# Impact Assessment Institute

The Institute for Impact Assessment and Scientific Evaluation of Policy and Legislation

"Impartial Analysis for Policy Making"

## Study scrutinising the

## Inception Impact Assessments:

Development of Secondary Markets for Non-Performing Loans - Ares(2017)3137460

and

Accelerated Loan Security - Protection of secured creditors from business borrowers' default - Ares(2017)3432908

IAI-NPL&ALS-171020

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## Main Findings

The Impact Assessment Institute has scrutinised the Inception Impact Assessments on Development of Secondary Markets for Non-Performing Loans and on Accelerated Loan Security. Whilst both Inception IAs provide a generally solid basis for further policy making, several issues of substantial concern should be taken into account as legislation is being drafted.

Development of Secondary Markets for Non-Performing Loans (NPLs)

- In the subsidiarity check, the need for action at EU level is justified ex-ante by the expected spill-over effects of non-performing loans. However, the evidence to determine the extent of the spill-over effect and thereby the need for EU action is absent, and should be presented in the full IA to inform the decision to legislate.
- The proposed policy options focus exclusively on EU harmonisation. Additional policy options should be considered that represent the full breadth of policy capabilities.
- A preliminary assessment of economic outcomes is provided, but no explicit evidence was presented to substantiate the expected effects, including as above spill-over effects. The possibility of confounding outcomes, such as a liquid market not arising, should also be factored into the analysis.
- Further assessment is required of the potential social consequences for debtors from a change in ownership of the debt.

Accelerated Loan Security

- No evidence, either quantitative or at least anecdotal, to substantiate the expected benefits and compliance with the subsidiarity principle, was provided.
- The policy options are consistent and have been signalled in previous European Commission communications.
- The analysis does not address the possibility that more widespread use of collateral could enable higher risk loans to be secured, thereby increasing the overall probability of default.

In both Inception IAs, additional information is required on the composition of the inter-service steering group to provide stakeholders with a full picture of the contributors. The format of the consultation (on NPLs) is welcome, as it enables stakeholders to provide written input.

The shortcomings identified above should be fully reviewed in the Impact Assessments that are under development, in order to ensure a solid evidence base for proceeding with legislation and for the policy provisions to be introduced.

## Visualisation

The following table provides a visual overview of the results of this report for each element of the evidence presented in the Impact Assessment, using an assessment from 1 to 7 to indicate the level of confidence (1 = highest, 7 = lowest confidence level).

| Element | Assessment level & description (1…7) | | Notes |
|---|---|---|---|
| Rhetoric | 2 | Minor questions identified on analysis and/or evidence | The language used is generally balanced and neutral. |
| Assumptions | 4 | Concerns identified with analysis and/or evidence | Little evidence is presented to support the assumptions quoted. |
| Background data | 4 | Concerns identified with analysis and/or evidence | Little information is presented about the role of regulation on the current market. |
| Analysis | 5 | Substantial concerns identified with analysis and/or evidence | Insufficient evidence was presented to support the preliminary assessments of impacts. |
| Results | 5 | Substantial concerns identified with analysis and/or evidence | Due to the concerns with the assumptions and analysis, the results of the preliminary assessment lack the necessary robustness. |
| Conclusions | 5 | Substantial concerns identified with analysis and/or evidence | Only one policy direction is given in the Inception IA on non-performing loans, which requires a broader set of options to enable robust further analysis. |

Key to assessment levels

| 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|---|---|---|---|---|---|---|
| Correct analysis, fully evidenced | Minor questions identified on analysis and/or evidence | Several questions identified on analysis and/or evidence | Concerns identified with analysis and/or evidence | Substantial concerns identified with analysis and/or evidence | Serious concerns identified with analysis and/or evidence | Incorrect analysis / evidence absent |

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# 1. Introduction and General Comments

This study scrutinises two Inception Impact Assessments (Inception IAs):

- "Development of Secondary Markets for Non-Performing Loans"
- "Accelerated Loan Security - Protection of secured creditors from business borrowers' defaults"

## 1.1. Secondary Markets for Non-Performing Loans

This Inception IA covers the development of a secondary market for non-performing loans (NPLs). These loans are prevalent on the balance sheet of banks in certain Member States and occupy capital that could in theory otherwise be used for new loans or other financial products. The reasons quoted for an underdeveloped market for NPLs include the lack of a single market for NPLs, the lack of a common backstop, and numerous regulatory obstacles within each individual Member State and for cross-border transactions.

Within the Capital Markets Union (CMU), the intended legislation is meant to remove the obstacles identified.

## 1.2. Accelerated Loan Security

The financial crisis left many European banks with high levels of non-performing loans (NPLs) on their balance sheets. These loans decrease the profitability of the banks and thus decrease the amount of available capital for other financial endeavours, including lending to businesses.

To decrease the amount of NPLs on balance sheets the Commission has proposed a two-part policy. First, accelerated loan security would allow banks to have increased access to collateral from businesses which would give them greater ability to make loans. Secondly, an out-of-court mechanism would allow banks to reach extra-judicial claims on the collateral. This is intended to decrease the amount of time and money spent on reclaiming collateral from NPLs and clear them off the balance sheet and thus, thereby to free up capital for use for beneficial purposes.

# 2. Inception IA on Development of Secondary Markets for Non-Performing Loans

The four sections A, B, C, and D of the Inception IA are assessed qualitatively in terms of the appropriateness of the rhetoric, assumptions, data and analysis presented.

## 2.1. Section A: Context, Problem definition and Subsidiarity Check

### 2.1.1. Context

This introductory part provides stakeholders with an overview of the legislative framework of this initiative, which is informative and presented clearly.

### 2.1.2. Problem the initiative aims to tackle

Problems with the current securities regime are identified in this section. The problems are adequately described and nuanced. However, the text does not address the inhomogeneity of markets for debt and in particular distressed debt across different Member States. If there are historical and/or cultural aspects that would cause EU policies to have widely different effects in different Member States, this would be a material impact to be assessed. It would be important to determine whether such factors exist and address them in the further assessment.

### 2.1.3. Subsidiarity check (and legal basis)

The Inception IA notes that the problem of NPLs is concentrated in certain Member States while stating that "spill-over effects" could hurt other Member States. This is the justification for a EU-wide policy. The text of this section only lists arguments that indicate why action would be needed at EU level. There is no mention of the possibility of alternative action being taken, which is of particular concern since no evidence of the spill-over effects has been provided (see also below). The full Impact Assessment should therefore carefully assess the cross-border impacts in order to inform a robust subsidiarity check.

## 2.2.Section B: Objectives and policy options

This section does not make a clear presentation of the objectives and the policy options under consideration, only providing a discussion of the main issues. Whilst the content is relevant and informative, there is no clear picture of the intentions that drive the policy forward.

No explicit policy options are presented, only a number of ideas that focus exclusively on a common EU approach and a harmonised set of principles. The variance between Member States with different starting points should be fully assessed. Additional policy options should be considered that represent the full breadth of available options, including leaving the market as it currently stands and the possibility of targeted reform in certain Member States, as well as EU-wide harmonisation.

The final paragraph refers to the consultation and the use of its results to inform the development of policy. It is the correct approach to gather input and then determine policy provisions. The responses to the consultation should be reviewed with the objective of extracting the evidence provided and combining this with other data sources to ensure a fully fact based policy. In particular further work should assess the impacts of different levels of harmonisation.

It is the function of the Inception IA to propose a preliminary set of policy options for further analysis and refinement, and in this case it has failed to do so.

## Section C: Preliminary Assessment of Expected Impacts

### 2.2.1. Likely economic impacts

The Inception IA projects the economic impacts of a developed secondary market for NPLs as being positive for the banking sector. In particular it states that a successful market would allow banks to sell these NPLs to a larger number of non-banks, increasing liquidity and reducing volatility of the NPL market which would free up capital for other purposes.

Even though these outcomes are qualitatively rational, they are not accompanied with supporting evidence nor any acknowledgement of potential confounding factors. The potential case of a liquid market not arising should be factored into the assessment. Further, it is not given that the increase in capital will mean increase in loans to other sectors of the economy, as this depends on a number of other factors.

It is also unclear how the benefits will be spread across the EU. As stated in the Inception IA the concentration of NPLs in banks is unique to certain Member States and the risk of "spill-over" is the reason it would bring about total EU benefits. There is no evidence or references to demonstrate this spill-over, nor a preliminary assessment of its extent, which would be the minimum necessary to inform the development of the policy measures even at this early stage.

A balanced assessment of all relevant effects is required, including an acknowledgement of potential drawbacks or barriers to realising the expected benefits.

### 2.2.2. Likely social impacts

This issue of NPL markets is functionally an exercise between banks which have NPLs and financial investors who may be interested to purchase and/or trade them. This could indirectly help the public as the banks with healthier balance sheets should be more stable and may be able to invest more. However, also relevant to social welfare (and fundamental rights) would be the consequences for debtors from a change in ownership of the debt. The Inception IA lightly touches on this issue, which requires further assessment.

### 2.2.3. Likely environmental impacts

Very few, if any, environmental impacts are expected and this is consistent with reasonable expectation of the effects of financial services regulation.

### 2.2.4. Likely impacts on fundamental rights

Impacts are likely to occur in the privacy and protection of consumers and debtors (see also social impacts above). The Inception IA correctly points out that equal treatment of both parties is difficult to balance and it is essential to ensure a system that works for both.

### 2.2.5. Likely impacts on simplification and/or administrative burden

This section of the Inception IA indicates that the streamlining of burdens and the subsequent simplification will vary greatly depending on the kind of policy option chosen and the extent of harmonisation that it brings about. This reference accentuates the need for preliminary policy options to be developed in this Inception IA (re Section 2.2 above) .

## 2.3. Section D: Data Collection and Better Regulation Instruments

### 2.3.1. Impact Assessment

The information provided on the Interservice Steering Group provides a list of directorates general involved, but it would be additionally informative to provide information on its leadership, the most actively involved directorates and their respective roles and relevant expertise. This is especially important due to the additional needs for the Impact Assessment as identified in the above sections.

### 2.3.2. Data collection

Data collection is sufficiently explained and covers all relevant aspects.

### 2.3.3. Consultation strategy

The text provides a clear description of how the consultation is to be conducted. Involvement of market agents, borrowers and public authorities is duly considered.

The consultation itself allows text answers and avoids multiple-choice questions, thereby ensuring stakeholders can fully express their views. It is open for fourteen weeks from 14$^{th}$ July 2017, which itself was two weeks after the date of publication of the Inception IA. This corresponds correctly to the Better Regulation Guidelines, which require consultations of 12 weeks duration on initiatives with Impact Assessments.

# 3. Inception IA on Accelerated Loan Security

The four sections A, B, C, and D of the Inception IA are assessed qualitatively in terms of the appropriateness of the rhetoric, assumptions, data and analysis presented.

## 3.1. Section A: Context, Problem definition and Subsidiarity Check

### 3.1.1. Context

This introductory part provides stakeholders with an overview of the legislative framework of this initiative, which is informative and presented clearly.

### 3.1.2. Problem the initiative aims to tackle

Problems with the current securities regime are described in this section. The Inception IA notes that only some Members States grant banks special rights which can broadly be interpreted as security rights. These rights are crucial to banks as they allow for the repossession of collateral in the case of a borrower's default. In particular the Inception IA focuses on a mechanism called accelerated security, which would allow banks to move extra-judiciously to repossess securities. The Inception IA states that:

> *"Secured creditors should be able to recover value from their security right swiftly and effectively, without being forced to wait for the result of judicial enforcement proceedings that are often suboptimal in terms of timing and recovery rate. This is even more important in cases of cross-border lending. These protections are currently not available to banks in all Member States. The fragmented legal framework and the inefficiency of the judicial system in the field of collateral enforcement represent a vulnerability for bank stability, with negative impact also on the capacity of financial institution to provide lending (especially to corporates)."*

Explicit evidence or references to substantiate this statement are not provided, nor is the number or identification of the affected Member States mentioned. Information demonstrating the quoted inefficiency, lack of extra-judicial power and recovery rate extensions should be quantified and at least evidenced by anecdotal accounts. This would provide a more concrete and credible platform for policy development. If the problems are as important and prevalent as indicated, the information should be readily available.

### 3.1.3. Subsidiarity check (and legal basis)

The Inception IA uses the pre-existing framework for extra-judicial security recovery by some Member States (Italy, France, Germany and the United Kingdom) and a set of soft-law recommendations adopted in 2010 by the United Nations Commission on International Trade Law as inspiration for this directive. These two points are salient and can serve as helpful guidelines to the directive. However, in this section some far reaching conclusions are made on the expected outcomes of this directive, prejudging the analysis.

The section uses language to justify the rationale for the directive, but only briefly addresses its stated theme of subsidiarity, in the last two paragraphs. The text of those paragraphs refers to the upcoming Impact Assessment and the resulting comparison of impacts of EU-level and national level action, which is the appropriate level of analysis at this stage.

Regarding economic impacts, the text states:

> *"As the initiative would help to overcome diverging court procedures in the Member States, cross-border lending would be incentivised and borrowers would have a better choice among lenders. This can promote the development and growth of companies (in particular small and medium-sized enterprises)."*

It is correct that a potential consequence of an increase in the ability of banks to give out loans would be incentivisation of cross-border lending as capital is freed up and the risk is lowered. However, this cannot be guaranteed to lead to an increase in loans to support the development and growth of SMEs. These loans could be given out to any number of agents and evidence is not presented that demonstrate SMEs will benefit in terms of the amount of loans made available.

A general statement is made regarding the EU impact which states:

> *"A greater convergence in EU secured loan enforcement systems could therefore benefit enterprises and consumers by making credit more readily available."*

It is true that the banks would have an increase in the capital they could loan out as credit to consumers and enterprises. It is also possible that the banks may choose to use this new capital for other financial products. This has the potential to counteract partly the expected effect of increased capital being used to support a greater volume of lending.

## 3.2. Section B: Objectives and policy options

### 3.2.1. Objectives

The general objectives are consistent and balanced, identifying the need to safeguard both the balance sheet of banks and support the consumers/enterprises in securing loans. This is intended to strengthen the economies of not only the individual Member States, but of the entire EU. The general objectives also seek to decrease the interest rates paid by collateral givers through increased options for collateral. The consistency of this with the specific objective to protect consumers requires additional assessment. The Inception IA comments on the need for careful assessment of assets as collateral. However, it does not address the possibility that, by increasing the availability of utilisable collateral, it may widen the availability of loans to less creditworthy parties or activities.

The specific objectives are coherent with the general ones and make a greater attempt at explaining the benefits for consumers as well as banks. The Inception IA mentions specific protection for collateral givers in limiting the scope of the accelerated security measure to business financial transactions, excluding private consumers. It also stresses the need for business borrowers to understand carefully the moveable and immoveable assets that they provide for collateral.

### 3.2.2. Policy options

The report identifies three potential policy options:

- Soft law instruments that provide recommendations for implementation of the accelerated loan securities as well as similar out-of-court collateral enforcements
- A legislative initiative aimed at harmonising the main features of the accelerated loan security
- A deeper level of harmonisation to provide for a detailed set of terms and conditions of an accelerated loan security that should be the same in all Member States

These three options were originally foreseen in the reflection paper on the deepening of the EMU[1]. These three options are sufficiently broad in the scope of their effects on Member States. Functionally they serve as a general best practice recommendation, a directive, and a regulation respectively. This is an adequate number of policy options that can be quantitatively assessed to identify the most effective option.

## 3.3. Section C: Preliminary Assessment of Expected Impacts

### 3.3.1. Likely economic impacts

The quoted economic impacts of an accelerated loan security mechanism, coupled with an out-of-court recovery mechanism, make qualitative sense provided that banks use the increase in capital in ways that actually benefit enterprises as intended. The logic follows that with the ability to give out credit more efficiently (through the accelerated process) and recover non-performing loans (through the out-of-court mechanism) that the banks would have more capital to lend across borders and to SMEs. This makes sense provided that it is profitable for the banks to make the aforementioned loans.

If the intention is to increase in available capital towards SMEs and cross border transactions rather than to other financial products, analysis is required on whether other provisions might be necessary to ensure this outcome. The Inception IA does point out that in its examination of this policy the analysis will include data from countries that have the out-of-court mechanism and accelerated loan security already in place, to assess the efficacy of policy measures.

An important issue that is not addressed in the economic impacts is the likelihood of more poorly financed loans being secured due to the increase in available collateral. This could incentivise banks to give out more loans for less creditworthy purposes, with the knowledge that they can use a variety of collateral to underwrite the loan and have the backing of an out-of-court system to retrieve the collateral if the loan becomes non-performing. This also requires further analysis.

### 3.3.2. Likely social impacts

The likely social impacts are highlighted including the need for these loan services to be focused primarily towards bank and business interactions to protect individual consumers. The Inception IA rightly points out that if these measures work as intended to create a more stable financial platform in EU, this also represents a social good. The one area untouched is the risk

[1] "Reflection Paper on the Deepening of the Economic and Monetary Union", European Commission, 31st May 2017

of an out-of-court mechanism failing. The potential for this mechanism to be used in such a way that it placed additional burdens on individuals or businesses, and potential provisions to avoid such an outcome, are not assessed.

### 3.3.3. Likely impacts on fundamental rights

Impacts are centred on privacy and equal treatment of debtors. The text states that the contractual nature of the loan security will be designed in a way to balance the ability of banks to recover collateral and the rights of the debtor. This is an appropriate intention, but constitutes an intention rather than a likely impact.

The Inception IA points out the ability for banks to pressure collateral givers into a contract given very low interest rates. This is a reiteration of the earlier point in this report that the increased availability of collateral, and ability to recover it, may result in more risky behaviour by the banks and a loss of important collateral to borrowers. The options for mitigating this, considering awareness for debtors and access to information regarding collateral and the banks' ability to repossess it, need to be fully assessed.

### 3.3.4. Likely impacts on simplification and/or administrative burden

This section reiterates the aim to ensure simplification and then presents a number of potential measures that are partly relevant to simplification. Evidence and references on the potential to simplify are not presented.

This section would more productively have presented a general overview of the potential for simplification through harmonisation of rules, in particular for cross-border transactions, against the potential for complication through the adoption of new rules. The final paragraph of the section is most relevant, stating "The consequences and costs of changing existing national regimes to align to a new EU regime will be assessed".

## 3.4. Section D: Data Collection and Better Regulation Instruments

### 3.4.1. Impact Assessment

As =for the Inception IA on NPLs, the information provided on the Interservice Group omits some important elements, in particular information on its leadership and the roles of the involved directorates.

### 3.4.2. Data collection

Data collection is sufficiently explained and covers all relevant aspects.

### 3.4.3. Consultation strategy

The text indicates that a legislative initiative is to be considered according to feedback from stakeholders. It is not clear whether this refers to the feedback to the Inception IA (4 weeks) or feedback to the eventual public consultation (12 weeks). This requires some clarification.

For this Inception IA, the four week period for stakeholder feedback was correctly applied according to the Better Regulation Guidelines.

## *Annex 1: Accompanying statement*

This report has been written according to the guiding principles of the Impact Assessment Institute: transparency, objectivity, legitimacy and credibility. It analyses the subject matter from a purely factual and scientific point of view, without any policy orientation. In respecting these principles it has been compiled following its written Study Procedures[2].

The analysis is open to review and criticism from all parties, including those whose work is scrutinised. In performing this work, the intention of the report is to be constructive in assisting the authors of the subject document and its background information as well as all relevant stakeholders in identifying the most robust evidence base for the policy objective in question. It should therefore be seen as a cooperative contribution to the policy making process.

This report is also to be considered as a call for additional data. Peer review is an essential step laid down in the procedures of the Impact Assessment Institute and this is manifested in the openness to further review and to identify new data. Input received in response to the draft version of this report is detailed in Annex I. Even at publication of the final version, the report remains open to newly arising data, information and analysis, which could be taken into account in a future revised version.

The Impact Assessment Institute is a private foundation incorporated in March 2016 under Belgian law, number 0650.623.342. The Institute is inscribed in the EU Transparency Register, number 993290221302-35.



[2] "Procedures for Conduct of Studies", Impact Assessment Institute, December 2015 (http://www.impactassessmentinstitute.org/#!procedures/c1q8c)