19 October 2017

RESPONSE VIA ONLINE QUESTIONNAIRE

Dear Sirs,

Response to the European Commission's Consultation Document: Development of Secondary Markets for Non-Performing Loans and Distressed Assets and Protection of Secured Creditors from Borrowers' Default (the Consultation)

The Loan Market Association (**LMA**) welcomes the opportunity to respond to the Consultation published on 10 July 2017 and hopes that its comments will be useful in your efforts in putting together a European strategy to accelerate the resolution of non-performing loans (**NPLs**), as well as formulating a view as to whether there is a legislative requirement to strengthen the ability of secured creditors to recover value from secured loans.

The LMA is the trade body for the European, Middle Eastern and African syndicated loan markets. Its aim is to encourage liquidity in both the primary and secondary loan markets by promoting efficiency and transparency, as well as by developing standards of documentation and codes of market practice, which are widely used and adopted. Membership of the LMA currently stands at over 670 organisations across EMEA and consists of banks, non-bank investors, borrowers, law firms, rating agencies and service providers.

By way of introduction, it may be worth noting that for a number of years the LMA has been providing guidance and standard form documentation to its members in relation to trading on the secondary markets. The guidance and documentation promotes a standardised approach to secondary debt trading, encouraging best practice and facilitating transactions to operate efficiently. The documentation is widely used in practice in the context of trades relating to loans which are governed by English law. We would be happy to provide you with copies of this documentation and guidance as you may find it helpful in your current review of the issues. In our view promoting voluntary best practice, has the advantage over further regulation of being faster to implement and more flexible in terms of being able to adapt to market demands.

Questions

Having consulted with our members in relation to the Consultation, we would like to respond to the following questions:

Section I: Secondary Market for Loans

Transfer of Loans

Question 1: Would you consider the current size, liquidity and structure of secondary markets for NPL in the EU an obstacle to the management and resolution of NPLs in the EU? If yes, would you consider such obstacle to be significant?

NPL markets are jurisdictional in nature and vary considerably as a consequence. That said we do not believe there to be significant obstacles in the management and resolution of NPLs across the EU.

In our view, the current size of the NPL market is a consequence of the financial crisis of 2007 - 2009. However, there has been a steady reduction in the level of NPLs across the EU, thanks in part to the specialised asset management companies set up to assist with the sale and management of NPLs. The successful NPL management by UKAR, NAMA, SAREB and BMAC underlines the liquidity available for NPL assets in particular jurisdictions. In each of 2015 and 2016, over €100 billion of non-core and NPL portfolios were sold across Europe (source: Deloitte), the vast majority of which were comprised of real estate assets. In 2017, the pace of asset sales has been tempered somewhat by the new ECB guidelines on NPL recognition and disposal strategy, also preparatory work for the implementation of IFRS 9. NPL sales in the first half of 2017 amounted to €42 billion, with some €87 billion in an extended pipeline (source: Deloitte).

It should be noted that the secondary market for individual performing and distressed corporate loan assets has been thriving for over 20 years, with annual trading turnover of ca. €60-70 billion over the last 5 years (source: Thomson Reuters).

The obstacles hindering the management and resolution of NPLs in the EU revolve around due diligence, and the availability and sufficiency of loan-level data (or lack of). Increasing the transparency of data around NPLs would be likely to increase liquidity in this market, better enabling banks to off-load legacy assets from their balance sheet via secondary markets for credit. Knowledge regarding jurisdictional issues, such as security and enforceability, play a large role in the liquidity available in each market, and the effective resolution of the NPLs therein. Secondary market investors need to educate themselves on local issues, including the state of the prevailing economy, before deciding whether or not to invest in any available NPL assets.

Question 2: What are the key considerations for banks in deciding whether loan sales should be a significant part of their strategy to manage its NPLs?

In answering please specify

- bank internal factors (i.e. any factors inside the bank including the type and characteristics of the NPL portfolio, management capacity etc.)

NPL sales are often dictated by provisions already set against the underlying assets. In addition, administrative costs will significantly impact the extent to which NPLs form part of their strategy, with banks having to consider whether or not they have the appropriate capacity and expertise to manage the work out of large NPL portfolios internally. Historical financial information and other data maintained by the bank may on occasion be incomplete, rendering sales significantly more difficult, although banks may be required to sell NPL portfolios as part of their strategy to manage the composition of their balance sheet.

- external factors (i.e. any factors outside of the bank)

Regulatory requirements, primarily derived from regulatory capital issues, place particular pressures on banks. For example, in the Spanish market, lenders typically opt to sell NPLs portfolios as a consequence of regulations on capital requirements (rather than lack of management capacity). Taking another example, in the German market, banks have been selling portfolios of NPLs recently in circumstances where it has been decided to close a particular business or branch.

Another key factor is the level of knowledge available for any one particular market. More developed NPL markets, such as those in the UK and Ireland, allow for relative value comparisons, whereas less developed markets are more likely to see pricing driven by the internal rate of return requirements of investment funds, together with the quality of loan-level data available.

that are important considerations in this context.

Question 3: What would be the best way(s) of attracting a wider investor base to secondary loan markets, especially for non-performing loans?

One way in which to attract a wider investor base to secondary loan markets would be to make it easier and less costly to transfer debt and security in NPLs. Across the EU, particular types of security require registration that is costly and time consuming. For example, in Spain the transfer of the benefit of a mortgage triggers stamp duty taxes and involves a lengthy documentation process. The automatic transfer of a perfected security interest to a new lender would significantly aid the market in attracting new investors. In addition, increased certainty that ancillary arrangements, such as hedging, account bank and letter of credit providers, will not be prejudiced by NPL transfers will further strengthen the attractiveness of the product.

Reducing settlement times for the secondary loan market would also increase the attractiveness of the product to additional investors, particularly those currently operating in the bond and equity markets. This could in part be achieved by streamlining know your customer (**KYC**) requirements. KYC is identified as the foremost reason for delays in secondary loan settlement, with the median secondary settlement times in Europe currently standing at 29.4 business days as at Q2 2017. This is in contrast to the US, where settlement times stand at 13 business days as at Q2 2017. One, and potentially the primary, reason for this is the US recognises investors in the secondary market as counterparties (as opposed to customers), allowing for a low risk approach to be adopted in respect of KYC checks. This approach is not adopted in European markets, due to a difference in regulatory approach.

Finally, clarity across Europe that the acquisition of a fully funded term facility is not an activity requiring a banking licence would open the investor pool to non-bank investors, such as debt and equity funds.

Question 4: In order to widen the investor base, please specify

- which incentive(s) should be given?

Regulatory capital relief would be a significant incentive, promoting liquidity in the secondary NPL market. NPLs, particularly distressed NPLs, can substantially affect the risk weighting of an investor's balance sheet, reducing or negating the commercial benefit of the transaction.

- whether certain obstacles to widening the investor base should be removed?

As set out in our response to Question 3, obstacles surrounding the transfer of debt and security in NPLs should be removed to widen the investor base.

There should be an automatic transfer of a perfected security interest to a new lender, which should be recognised under the insolvency law of each EU state. In addition, better guidance surrounding KYC requirements, with a view to reducing secondary settlement times, would attract more investors to the syndicated loan market as a whole.

Changes like these would help speed up the NPL market, to allow quick transfers (and market participants as participants would be more confident as their insolvency risk to the grantor would be reduced), reduce costs and facilitate securitisations.

In addition, the removal of local licensing arrangements on who may own loans would assist in broadening the market.

Question 5: What are the specific advantages to the development of secondary markets when the acquiring investor is a bank, an investment fund or another type of entity?
In particular, would you see specific advantages for creating investment opportunities for specialised investors?

The ability to sell non-core assets to a third party investor frees up capital for the original lender to more efficiently deploy elsewhere. Furthermore, the acquiring entity may be more specialised in the monetisation of the underlying receivables, the realisation of security or workout in general (these assets are more likely to be non-performing). This could increase the likelihood of a successful workout, enabling a greater repayment of debt owed to creditors.

An acquiring bank is more likely to purchase performing loans, with a view to building/developing its franchise in the sector by virtue of the purchase.

Question 6: What are the main concerns linked to each of these investor types?

Where the acquirer is another bank, then the borrower may get some comfort that the loan relationship will be continued in the same way as with the original lender. When other participants purchase the loan, they may have other motivations that do not involve the continuation of the relationship. For example, in the distressed arena it is not unusual for the purchaser to have a "loan to own strategy" or be driven by a quick realisation process, with little sympathy for the borrower's state of distress, but reflecting the acquirers valid commercial strategy.

Question 7: What are potential benefits and risks from a public policy point of view when considering the appropriate legal framework for secondary markets for loans, and especially NPLs?

Please rank the following dimensions (in order of importance):

The priorities are really dependent upon the different stakeholder interests. From the lenders' perspective the duty of confidentiality is paramount, from the investors' perspective they want enough information to be able to assess the transaction and ensure they get the pricing correct. Prices may be influenced by the ease and amount of information available. From the debtor's perspective, protection of their business takes priority. Looking at each in turn:-

(1) debtor protection,

Debtor protection is vital for a fully functioning secondary loan market.

(2) privacy,

Privacy is a fundamental principle of the syndicated loan market. It is a key characteristic in attracting borrowers to the syndicated loan market as against other financial products.

(3) data secrecy,

As stated above, better availability of loan-level data would be likely to attract more investors to the secondary loan market. However, the provision of this data needs to be careful balanced against the private nature of the market.

(4) promoting increased market size and depth and equal treatment of investors

The extent to which the promotion of the market would benefit the secondary market for loans would depend on what form such promotion would take. Ensuring equal treatment, and more importantly protection, of investors would aid in the expansion of the investor base.

Question 8: How can one best strike the balance between such dimensions?

Currently we promote the use of confidentiality agreements that seek to address issues relating to privacy and data secrecy, and balance the different perspectives. In terms of who may acquire the loans, contractual limits or restrictions may apply to protect the debtor, so that consents to transfer must be sought.

Question 9: Do differences in these benefits and risks across Member States justify national differences in the framework for secondary markets for loans? If yes, in which way?

Although there are some differences, we think this is something which is best addressed in the contractual arrangements between the parties.

Question 10: Would you consider current rules applicable in Member States pertaining to secondary markets for NPL in the EU a significant obstacle to the further development of these markets?

As mentioned above, ownership limitations in certain jurisdictions can be restrictive.

Question 11: What is the most suitable manner to protect a debtor in the case of transfer of a loan and/or collateral by the creditor to a third party?

In the context of an NPL, the relationship between debtor and creditor is complex. The debtors often look to preserve concessions that existing lenders may provide, or begin to explore transgressions that the existing lender (or its servicer) may have done in order to get out of payment, or delay or otherwise minimise payment. New lenders typically acquire loans with a view towards enhanced servicing and, where needed, enforcement.

The balance has to be addressed so that the transfer is neutral – borrowers should not be prejudiced by a new lender, but at the same time new lenders are often looking not only at the quality of the loan / security for repayment, but how to address and minimise the risks of the existing lender (and its servicer) on the loan recovery. Failing to suitably balance the competing interests would make NPLs less appealing or could otherwise fail to generate suitably competitive bids for NPL transfers. At present, contractual consent mechanisms work well.

Question 12: What are the (potential) advantages from specialisation across jurisdictions or asset classes?

The more standardised the market becomes, with specialisms across jurisdictions or asset classes, the more efficient the process of transfer becomes from a time and costs perspective.

Question 13: Are you aware of obstacles to operating in secondary markets across national jurisdictions? Would you consider these obstacles to be significant, and/or influence your geographical scope of business operations?

The current lack of an automatic transfer of a perfected security interest across national jurisdictions, as mentioned above, acts as a significant barrier to the geographical scope of business operations. Clarity across the EU, recognising that a designated party (such as a security agent / trustee) may hold security and other rights and benefits for a group of lenders, is strongly desired.

In addition, those jurisdictions that impose limitations on the identity of the owner, as mentioned above, can influence the scope of business.

Question 14: Do you consider that an EU regulatory framework (Directive or Regulation) regulating certain aspects of the transfer of loans would be useful? What are in your view the key elements that should be addressed in such a framework?

We do not consider that regulation of the transfer of loans would be useful or desirable. The secondary market for both performing and non-performing individual corporate loan assets in Europe is well established. Together with NPL and non-core portfolio sales (mainly real estate in nature), over €1 trillion has been sold in the European secondary market since the advent of the financial crisis (source: Thomson Reuters, Deloitte).

Removing possible constraints to the development of secondary markets for loans

Question 25: Are you aware of significant differences in business practices in different markets and jurisdictions, for example through voluntary codes of conducts, industry standards, etc.? If yes, does this, and how, constitute an obstacle to your business?

As mentioned above, the LMA promotes best business practice, and standard form documentation across EMEA secondary loan markets, rather than further regulation.

Question 28: What specific aspects could be improved, in order to facilitate existing cross-border activities and/or entry into new markets? Going beyond mere facilitating, what would accelerate the resolution of NPLs?

The adoption of market standard documentation, such as that provided by the LMA, could facilitate cross border transactions and lower barriers to entry in new markets.

Question 29: Do you consider that the development of a common EU approach would have an added value in the areas of the sale and transfer of loans?

A standard approach to the sale and transfer of single loan sales already exists in the European market. Standard form trade documentation and market practice guidance was established in 1997 by the Loan Market Association, and is widely used across the market.

However, standard form documentation has yet to be developed specifically for loan portfolio transactions, with documentation being negotiated on a case-by-case basis. This is time consuming and costly for investors. The development of a common EU approach to the sale and transfer of loan portfolio transactions, and specifically the creation of a standard form of sale document for NPLs, would likely speed up settlement of NPL transactions and help create liquidity in the market.

Section II: Potential Mechanism to Better Protect Secured Creditors from Borrower Default

Rationale for an EU accelerated loan security

Question 31: Do similar forms of out-of-court enforcement allowing banks to enforce secured loans exist in your country? If yes, - please describe these. - what are the benefits of these provisions for banks in terms of enforcement and value recovery from NPLs? - what are the main risks and challenges arising from these forms of out-of-court enforcement tool?

As mentioned above, we represent members from a number of different jurisdictions. The ability to rely upon out-of-court enforcement varies from relatively sophisticated out-of-court procedures in England to court driven enforcement in a number of other European member states. There are obvious costs and time efficiencies that are derived from an out-of-court process which can lead to better recoveries.

It is worth noting that banks in Europe also benefit from the European Financial Collateral Directive, which allows financial collateral arrangements to be enforced by way of appropriation and no court involvement. The Directive has been implemented in different ways and is dependent upon an arrangement falling within a specified category. Generally speaking the Directive has been welcomed by lenders who have benefitted from its application, and have as a consequence avoided the need to resort to the courts. Of course part of its effectiveness relied upon the fact that it switches off the debtor protections derived from insolvency laws, which is not what is envisaged here. As a result of which we consider that practically the enforcement mechanism being promoted here may not get much traction.

Conclusion

We would be happy to discuss any aspect of this response with you in more detail and to meet with you as required. If we can be of any further assistance, please do not hesitate to contact either myself of Gemma Haley via email at nigel.houghton@lma.eu.com / gemma.haley@lma.eu.com or by telephone on +44 (0) 207 006 1207 / +44 (0) 207 006 1372.

Yours sincerely

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