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NON-PERFORMING LOANS: ADDRESSING LEGAL AND REGULATORY IMPEDIMENTS

This article discusses legal and regulatory challenges to non-performing loan (NPL) resolution. It emphasises that tackling high levels of NPLs should not focus merely on the impediments contained in insolvency and enforcement frameworks. Addressing legal and regulatory impediments to NPL resolution requires a much broader and comprehensive approach that must include all areas of law.



BACKGROUND

Concerns related to high levels of NPLs are very high on the agenda of many emerging economies. Following the financial crisis of 2008, many countries, especially those in central and south-eastern Europe,¹ are still experiencing high levels of NPLs. Studies show that high NPL levels significantly impact on banks' lending, economic recovery and ultimately on economic growth.² Numerous studies issued in the last few years have demonstrated a strong correlation between the level of NPLs and credit/GDP growth. One of the authors of the Vienna Initiative discussion paper³ summarises the impact of NPLs:

"...There are two main channels through which NPLs could hold back economic recovery. Firstly, banks saddled with NPLs may be ill-placed to extend fresh credit. Secondly, overextended borrowers face reduced incentives to invest and assets remain under their control rather than being reallocated to more productive users".

One of the recent IMF discussions suggests that NPL resolution in Europe should be based on three pillars:⁴

- "...enhanced prudential oversight to incentivize banks to write off or restructure impaired loans, including efforts to foster more conservative provisioning and imposing time-bound restructuring targets on banks' NPL portfolios..."
- reforms to enhance debt enforcement regimes and insolvency frameworks. Effective out-of-court restructuring frameworks and improved access to debtor information should be encouraged
- development of distressed debt markets by improving market infrastructure and, in some cases, using asset management companies (AMCs) to jump-start the market".

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It is important to note that all these areas are interconnected and must be addressed collectively. Although resolving NPLs is primarily the task of each affected bank, due to the potentially detrimental effects of high and persisting NPL levels to the entire economy, NPL resolution requires the broader concerted action of governments, regulators, international financial institutions and the private sector. It necessitates a multidisciplinary approach and only a complete set of measures may lead to efficient NPL reduction.

A good example of a concerted approach to NPL resolution (at the international level) is the Vienna Initiative⁵ that brings together the public and private sectors to discuss, among others, issues connected to NPL resolution and to examine efficient solutions for tackling NPLs. Nationally, Serbia is one of the countries that approached the problem very comprehensively and systematically.⁶

ADDRESSING LEGAL AND REGULATORY IMPEDIMENTS TO NPL RESOLUTION

In the past few years, it seems that many countries have focused predominantly on addressing legal impediments contained in insolvency and enforcement frameworks (the IMF's second pillar, for example, emphasises the importance of this). Although it is obvious that inefficiencies in insolvency frameworks include the most common and severe legal impediments to efficient NPL resolution, we should not however overlook other legal areas that might also have a detrimental effect on NPL resolution. The IMF's research shows that the degree of concern about the overall judicial system is generally higher than the degree of concern about corporate and personal insolvency.⁷ This observation indicates that the problem of legal impediments is much broader and systemic. In this respect, perhaps the second pillar of the IMF proposal could be extended to all legal areas that might include obstacles to efficient NPL resolution (with some of those legal areas being pointed to in this article).

In order to identify all legal impediments to NPL resolution in a particular jurisdiction, a detailed and comprehensive analysis of a legal system has to be conducted. Without such analysis it is possible that an important but not-so-obvious impediment to NPL resolution is overlooked. Such analysis cannot be done solely via desktop analysis but must include field research, for example, interviews with banks, investors, advisory firms and other authorities.

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GROUPS OF IMPEDIMENTS

As indicated above, NPL resolution is a complex task that requires a multidisciplinary approach of various expertise (for example regulatory, tax, accounting, legal, finance, banking). In general, a bank has two options for tackling NPLs:

- dealing with NPLs internally. There are several solutions for how the banks can deal with NPLs internally (for example, internal workout departments, outsourcing). The main characteristic of this technique is that the NPLs stay on the banks' balance sheets.
- transferring part of or the whole NPL portfolio to another entity. A bank transfers its distressed portfolio in order to remove bad loans from its balance sheets (for example, selling it on the market, transferring it to a special purpose vehicle).⁸ This method includes any type of risk-sharing agreements.⁹

Many experts believe that the transfer of NPLs is a more appropriate approach for banks as they should focus on their primary activity and not be distracted by NPLs. Considering these two possibilities, we could divide legal and regulatory impediments into two groups:

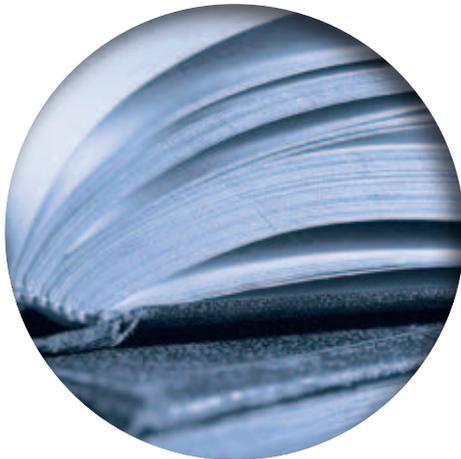
- impediments to NPL resolution *per se*. This (first) group contains those legal and regulatory impediments that have a detrimental effect on the resolution of NPLs irrespective of which entity (bank, investor, asset management company) is resolving the NPLs.
- impediments affecting a transfer of NPLs from one bank to another entity. This (second) group refers to those legal and regulatory impediments that obstruct a transaction for transferring NPLs from a bank to another entity and impediments that hinder the functioning of the entity that took over the NPLs.

IMPEDIMENTS TO NPL RESOLUTION *PER SE*

This group of impediments affects all entities that are dealing with NPL resolution. In general, legal impediments for this group are usually found in insolvency and enforcement frameworks (for example, cramdown, a lack of fast-track bankruptcy procedures, deficiencies in insolvency administrator frameworks). In past years authorities in different European countries were more focused on these types of impediments,¹⁰ which is quite understandable as improving the insolvency legislation is almost a pre-condition for efficient tackling of NPLs.

IMPEDIMENTS AFFECTING TRANSFER OF AN NPL

This type of impediment is rarely contained in insolvency and enforcement frameworks. Usually most of these impediments are of a regulatory nature (for example, data privacy, licensing requirements). However, other legal areas (for example, civil procedure, laws regulating contracts) may include provisions that impede transfer of NPLs.



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DEVELOPMENT OF DISTRESSED DEBT MARKETS AND LEGAL IMPEDIMENTS

In many European countries (especially in south-eastern Europe) a distressed debt market is illiquid and almost non-existent. There are many different obstacles (legal, regulatory, tax, accounting, price gaps) that discourage investors from entering those markets.

Legal impediments do not solely affect NPL resolution as such, but also hinder the development of distressed debt markets. An underdeveloped legal system does not only impede a resolution of NPLs in terms of slow and inefficient enforcement and insolvency frameworks, but an aggregate of both types of legal impediments may prevent the development of a distressed debt market. Therefore, both types of legal and regulatory impediments have to be addressed in order to facilitate the development of distressed debt markets. Namely, an investor in NPLs will analyse both groups of impediments in a particular legal system and on the basis of such analysis decide whether to enter a particular market and what price he is willing to pay for a particular distressed loan/portfolio. Basic analysis would seem to suggest that the former group of impediments affects the price of a loan more than the latter, while the latter affects the investor's decision whether to enter the market or not.

- 1 For example, Croatia, Serbia, Slovenia, Romania, Bulgaria, Hungary, Cyprus, Greece (for more information on NPL levels in different countries visit <http://data.worldbank.org/indicator/FB.AST.NPER.ZS> last accessed 8 January 2016)
- 2 For example: N. Klein (2013), Non-Performing Loans in CESEE: Determinants and Impact on Macroeconomic Performance, International Monetary Fund, Washington, DC.

Asset management companies are widely recognised as an effective solution for tackling NPLs and also investors will most likely enter the market through some type of asset management company. There are also different impediments that prevent the functioning of such companies. This type of impediment may be seen as a sub-type of impediment that affects a transfer of NPLs or it might even be categorised as a separate (third) group of impediment.¹¹

PROHIBITION OF RETROACTIVITY

In my view, prohibition of retroactivity is an additional challenge for addressing legal impediments. In general, *ex post facto* laws are prohibited (also in civil frameworks), which means that some changes in the legal frameworks (especially changes to contract laws) will have an insignificant effect on the existing NPL levels. Namely, in some cases a legislator may have difficulties introducing changes that would affect the existing relationship between a lender and a borrower, since some legislative amendments may only affect future legal relationship.

THE EBRD'S STUDIES

Considering the complexity of NPL resolution, different departments of the EBRD are actively involved in questions related to this topic. The EBRD's Legal Transition team plays an important role in these tasks and deals with different aspects of NPL resolution. Recently, the EBRD prepared two detailed analyses of impediments related to NPLs, in collaboration with external international and local experts:

- in Hungary, an extensive report has been prepared that covers all impediments to NPL resolution
- in Serbia, the analysis was focused on impediments to the sale/transfer of NPLs.



3 G. Impavido, C. Klengen and Y. Sun (2012), European Banking Coordination "Vienna" Initiative Working Group on NPLs in Central, Eastern and Southeastern Europe, page 23 (visit <https://www.imf.org/external/region/eur/pdf/2012/030112.pdf> last accessed 8 January 2016).

4 S. Aiyar et al (2015), A Strategy for Resolving Europe's Problem Loans, IMF Discussion Note, Washington, DC.

5 For more information visit: <http://vienna-initiative.com/> (last accessed 8 January 2016)

6 For more information visit: [http://www.mfin.gov.rs/UserFiles/File/strategija%20kreditu/2%20NPL%20Strategija%20\(eng\).pdf](http://www.mfin.gov.rs/UserFiles/File/strategija%20kreditu/2%20NPL%20Strategija%20(eng).pdf) and http://www.nbs.rs/internet/english/55/npl/action_plan.pdf (last accessed 8 January 2016)

7 S. et al (2015), Strategy for Resolving Europe's Problem Loans, Technical Background Notes, page 17.

8 Another, perhaps rarely used option is that a bank transforms itself directly into an asset management company (for example, Hypo-Alpe-Adria Bank International AG).

9 By this method the original lender remains a party of the loan agreement with all rights and obligations against the borrower and the "buyer" does not obtain any direct entitlements against the borrower but only against the lender. This type of transaction is also known as a synthetic sale and is more commonly seen in Germany and France.

10 The IMF Technical Background Notes (September 2015) contain a list of European countries that changed their insolvency legislation in the past years.

The EBRD's analyses reveal some interesting examples of impediments that could be categorised within the second group of impediments:

LICENSING

Some jurisdictions contain provisions that allow a transfer of a loan only to certain entities that have a licence for providing financial services (for example, Hungary). A potential purchaser of a loan would have to apply for such a licence before the transaction. Obtaining such a licence can take several months (in Hungary, up to 180 days).

In Serbia, for example,¹² retail loans can only be assigned to another entity that is a Serbian licensed bank. As the investors in distressed debts are not usually banks, this provision may obstruct development of a market for distressed loans.

CIVIL PROCEDURE

According to the Serbian Civil Procedure Law the defendant has to give its consent in case the plaintiff changes during the litigation. The Serbian Commercial Court of Appeal has taken the position that the existing litigation has to be finished before an NPL is sold. If the NPL is sold during the litigation procedure, the buyer of such a loan will eventually lose in the litigation.

CONTRACT LAW

A provision that might have an adverse effect on the development of the NPL market in Serbia can be found in the Serbian Code of Obligations, according to which capitalisation of due interests is only allowed for banks in case of a loan transfer; the purchasing entity (other than the bank) would

not be able to charge interest on capitalised interests. This impediment would most likely not affect the investor's decision to enter the market or to buy a particular loan, but it would affect the price of the loan and it represents a counter-incentive for distressed debt market development.

DATA PROTECTION

Obstacles related to data protection have been raised in several countries (for example in Austria),¹³ In many countries (for example, Serbia) frameworks regulating data protection do not clearly exempt an NPL transaction from the data privacy obligations. These provisions severely impede development of the distressed debt market as an investor cannot perform an appropriate due diligence allowing the evaluation of a potential investment.

CONCLUSION

A high level of NPLs has a negative impact on economic growth. Efficient tackling of NPLs requires the concerted approach of governments, international financial institutions and the private sector. It is important that each country performs a comprehensive analysis of its legal and regulatory frameworks in order to determine all relevant obstacles that impede effective NPL resolution. Countries must not overlook legal and regulatory impediments that prevent a transfer of NPLs and that discourage the development of a market for distressed loans, in particular.

¹¹ Li Jiangfeng categorises legal impediments into two groups: impediments on primary markets and impediments on secondary markets (that is, impediments related to functioning of asset management companies). See L. Jiangfeng (2013), Non-performing loans and asset management companies in China: Legal and Regulatory Challenges for Achieving Effective Debt Resolution and Recovery, Peking University School of Transnational Law, Peking.

¹² That is, a loan given to a natural person.

¹³ M. Ebner (2014), Schoenherr Lawyering Guide: Non-performing loans, 2nd edition, Schoenherr, Vienna. (http://www.schoenherr.eu/uploads/tx_news/RZ_NPL_Guide_new_18072014_online_D.pdf last accessed 8 January 2016)

