WHITE & CASE

Financial Regulatory Observer

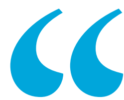
The Financial Regulatory Observer regularly sets spotlights on selected topics driving the regulatory and technological changes in the financial industry.

June 2018

Modernizing Europe's regulatory framework for outsourcing

Digital transformation has become a key topic across financial institutions' board rooms. Yet the regulatory framework for the implementation of technological innovations still lags behind.

The modernization of IT infrastructure is a crucial issue for many banks and financial institutions. However, the regulatory framework often fails to keep pace with technical developments and makes it unnecessarily difficult for banks to use new technologies. This has now also been recognized by supervisory authorities.



The regulatory framework must evolve quickly to catch up: A reform of outsourcing rules is on the horizon in 2018

IT modernization as a decisive competitive factor

The IT infrastructure within established banks is often outdated, overly complex and in desperate need of modernization. Some banks still work with software solutions that are decades old. Financial institutions have grown and evolved through mergers and acquisitions, but often without a full IT integration or upgrade. The result is a complex infrastructure with a high proportion of manual, error-prone and slow processes in the middle and back office. The associated costs increase the pressure to modernize in a time of low returns.

The emergence of new challenger banks with lean business models, newly built IT infrastructures and fully digitalized value chains have added to this pressure, while new technological developments such as Big Data, the use of artificial intelligence, cloud solutions and distributed ledger technology (DLT) are forcing banks to modernize their IT structures. Many of the new IT solutions are now offered only in the cloud or allow the use of all functionalities only in the cloud. Distributed ledger solutions also require a modern IT infrastructure and are often combined with cloud-based solutions. A cooperation with competitors and fintechs would hardly be conceivable today without modern API-based interfaces.

IT infrastructure is not only a major cost driver, but is also a decisive factor in determining the industry's future winners and losers. Those financial institutions that succeed in quickly establishing an efficient and modern IT infrastructure and in digitalizing and continuously optimizing the value chain will be able to survive in competition.

Regulatory pressure continues

Against this backdrop, it is not surprising that supervisory authorities have started to look at the modernization of IT as one of the most important regulatory topics, not only from the point of view of risk management and IT security, but because stricter regulation increasingly requires banks to call up and link a large number of different data points at the push of a button. Finally, regulatory pressure stems from concerns about weak earnings in the banking sector and the potential disruption of traditional business models by fintechs and alternative players.

Focus on outsourcing rules

As a result, the degree and the complexity of outsourcing IT and business processes are continuously increasing in the financial industry, while the competitive landscape of service providers is also changing. Until just a few years ago, IT outsourcing solutions were tailor-made for the needs of the individual financial institution, purchased mainly from national service providers and service providers specializing in the financial sector. Now, multi-client service providers are increasingly dominating the market, promising growth in efficiency and cost reduction through standardization and the use of economies of scale. Specifically, the tech giants offer cloud-based solutions on a global basis. The importance of outsourcing regulations has also grown because many of the new IT-supported solutions are increasingly purchased as services and therefore can fall under the regulatory outsourcing rules.

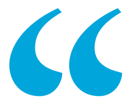
Outsourcing rules: A perpetual "construction site"

Over the past 25 years, an ever-more differentiated set of rules for outsourcing in the financial sector has emerged. In Germany, the rules for credit institutions and financial services institutions are traditionally laid down by the German Federal Financial Supervisory

Authority (BaFin) in section AT 9 of the Minimum Requirements on Risk Management (MaRisk). This includes the identification and ongoing monitoring of outsourcing relationships by the risk management and internal audit departments of financial institutions. In the case of material outsourcing, the outsourcing contract has to specify in particular the rights to information and the audit rights of the internal and external auditors of the financial institutions and of the supervisory authorities. Another focus is to ensure compliance with data protection regulations and other security requirements. The supervisor also requires contractual regulation of the possibilities and conditions of sub-outsourcing and compliance of financial institutions with regulation also in case of sub-outsourcing.

In October 2017, BaFin published its latest amendment to the MaRisk, which tightened regulations on outsourcing management, adding the requirement of central outsourcing management and appointing outsourcing officers. A month later, it published its Supervisory Requirements for IT in Financial Institutions (BAIT), which further specify the rules and regulations for IT risk management, including outsourcing and other external procurement of IT services.

These provisions are principle-based and technology-neutral. For example, BaFin most recently confirmed in the BAIT that the provisions of AT 9 of MaRisk should apply without restrictions to the procurement of cloud solutions. However, neither the MaRisk amendment nor the BAIT go far enough in bringing the IT outsourcing regime up to date.



A patchwork of European outsourcing rules makes the group-wide sourcing of IT solutions difficult for multinational financial institutions

European patchwork

The outsourcing rules are poorly developed at the European level. For example, the European Union's Capital Requirements Directive (CRD IV) mentions the issue of outsourcing only in passing as part of appropriate risk management. Otherwise, the European supervisory framework for outsourcing by banks continues to be determined by the guidelines of the Committee of European Banking Supervisors for Outsourcing (CEBS) developed 12 years ago. These guidelines lay out some basic principles for a uniform supervisory framework for outsourcing. However, a full harmonization of the outsourcing rules and the practice of supervisory authorities has not been achieved. To make matters worse, a slew of other EU directives, from AIFMD, MiFID2 and EMIR to PSD2, have implemented sector-specific outsourcing rules that are also relevant for banks.

The result is a European patchwork of outsourcing rules and administrative practices that makes the group-wide sourcing of IT solutions difficult for financial institutions with international operations. Although national outsourcing rules are mostly based on common basic principles and building blocks, the regulations and practice of national supervisory authorities differ considerably in detail. For example, in some countries and sectors, significant outsourcing must be notified or even approved in advance, while in other countries and sectors, periodic collective reporting is sufficient. The rules and administrative practice regarding chain outsourcing, the agreement of audit and instruction rights and the detailing of safety requirements or business continuity management also differ quite considerably. The European Central Bank's (ECB) unified supervision of the largest credit institutions in the Eurozone has done little to change this. Since many of the national regulations have been enacted at the legislative level, they do not fall within the purview of a unifying practice adopted by the ECB.

Supervisory authorities react

The European authorities have now recognized the urgent need for action. In December 2017, the European Banking Authority (EBA) launched its final recommendations for the use of cloud service providers by financial institutions. The EBA is also looking to implement a new version of the outsourcing guidelines that are intended to replace the CEBS guidelines. The ECB has recently announced that it will issue its first uniform guidelines for outsourcing by financial institutions it supervises later in 2018 and will soon launch a consultation on this subject. In addition, ECB plans to publish later this year specific guidelines for IT risk management.

ECB is due to issue its first uniform guidelines for outsourcing by major banks later this year.

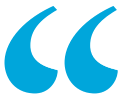
At the national level, regulators and supervisors also continue to be active. In April 2018, BaFin clarified its administrative practice on rights to information, audit and control rights with respect to cloud solutions. Shortly thereafter, BaFin Chief Executive Director Raimund Röseler announced the prospect of a further revision of the outsourcing rules, particularly with regard to cloud solutions.

Technology openness instead of technology neutrality

The benchmark for the upcoming revision of outsourcing rules must be whether it enables banks to make full use of new technologies such as cloud solutions and distributed ledger technologies and to integrate these new technologies into their business models while ensuring the necessary level of risk management, security and regulatory compliance.

However, the existing regulatory framework is still strongly influenced by the model of traditional bilateral outsourcing relationships, where financial institutions purchase a tailor-made solution from a service provider and negotiate the related contract documentation with them.

This model no longer reflects the procurement processes of many of today's outsourcing services. For example, today's public cloud platforms are necessarily standardized to the highest degree so an individual financial institution has little or no influence on the global offering of the cloud service provider or the contractual structure. This results in a paradigm shift for the bank's risk



A rapid IT modernization and digitalization of the entire business model is becoming a matter of survival for many financial institutions

management, as the bank's concrete use case and the associated internal risk management processes will have to be adapted to the regulatory and security requirements and the provider's standardized offer, rather than the provider adapting to the bank's individual expectations.

For the regulatory framework for outsourcing activities, financial institutions will need more flexibility so they are not hindered in the use of new technologies. A first step in this direction would be a clarification by the supervisory authorities that the audit rights of the financial institutions may also be exercised based on group audits. For example, in the case of mass procurement of standardized cloud solutions, it is neither necessary nor appropriate for each institution to audit the IT service provider individually. The EBA recommendations now explicitly provide for the possibility of group or pooled audits with other customers of the cloud providers they use. BaFin also confirms this possibility in its most recent statements, but without waiving the need for an individual right to audit.

However, the need for adaptation does not stop at audit rights. Instruction rights, which under MaRisk have to be agreed by banks with service providers "to the extent necessary", cannot be enforced against cloud providers offering their services to thousands of other companies in a standardized manner, nor do such rights make sense overall.

Against the background of global service providers with a vast number of third-party actors and multi-stage outsourcing chains, the current requirements for sub-outsourcing of services also seem excessive and unrealistic. Neither the necessity "to agree on consent requirements to the extent possible" nor the general passing on of supervisory obligations to the subcontractor appear practicable or—from the point of view of risk management—expedient and proportionate. It is not surprising then that BaFin's Röseler expressed doubts about whether "our existing rules are still really useful in practical life".

No widespread adoption of new technology without a uniform regulatory framework

For many financial institutions, a rapid IT modernization and the digitalization of the business model and of the entire value chain is becoming a matter of survival. Regulators and supervisory authorities should ensure that the regulatory framework does not hamper the use of new technologies, such as cloud solutions. Many of the new technologies help financial institutions not only to reduce costs, but are also necessary for the digitalization of their business model and also offer advantages from risk management and IT security perspectives. Widespread adoption of new technologies can only be achieved through a European regulatory framework that is technology-friendly, uniform and legally certain. In the meantime, there's hope that EBA, ECB and BaFin will take this sufficiently into account when revising their outsourcing rules.

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US cross-border securities: Buyer (and seller) beware

As technology removes physical borders from the securities industry, international financial institutions must remain vigilant to ensure their business activities do not violate US regulations.

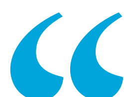
Since the financial crisis, the US has strengthened its position as the world's biggest and most liquid capital market and one of the most active destinations for M&A, equity fund-raisings and securities trading. This makes it an essential market for international financial institutions eager to build businesses and win market share.

In an increasingly electronic world where physical boundaries are no longer impediments to the efficient delivery of financial services, there are many ways in which non-US securities firms can target US investors and markets. However, they must be aware of significant legal and regulatory risk, particularly in light of an increased focus by the US Securities and Exchange Commission (SEC) on policing the activities of foreign securities firms.

International companies must formally register with US regulators if they are not exempt from registration, or they could face penalties, as illustrated by recent enforcement, actions by the SEC.

In 2016, Israeli based Bank Leumi was forced by the SEC to pay nearly US$5 million in penalties to settle charges that it provided investment advice and solicited investments from US customers without registering with federal regulators.

The SEC has brought similar cases in recent years against financial institutions targeting US investors and markets from other countries including Russia, Portugal and Switzerland.



Non-US companies that are not exempt from registration with the SEC may face fines for providing investment advice or brokerage to US customers without registration

Passing the registration test

Unless an exemption is available, US law requires any person soliciting or selling securities to persons in the US to register with the SEC as a broker. The basic test for "broker" status is whether a person performs any activity that could be deemed as "effecting a transaction" in securities and receives a fee based on the size or completion of the transaction—so called "transaction-based compensation." While there is no established list of activities that could be deemed "effecting a transaction," the SEC and US courts have cited the following activities as problematic:

- Identifying and/or introducing potential purchasers of securities
- Communicating with US investors via telephone or email, or traveling to the US to meet with investors
- Establishing or maintaining brokerage accounts for US residents
- Soliciting securities transactions (e.g., advertising a company for sale, offering brokerage services or financial products to US residents, etc.)
- Distributing securities research reports to US persons
- Participating in the negotiation of a securities transaction and
- Facilitating the execution/closing of a securities transaction

Any person—based within the US or who engages in these or similar activities with US customers—should consider whether they must first register with the SEC as a broker, particularly when these activities are combined with transaction-based compensation.

US$5 m

Penalty imposed by the SEC on Bank Leumi for failure to register

Offering investment advice to US customers

If a person provides advice to US clients about buying and selling securities, or in relation to the valuation of securities, they will typically be required to register with the SEC as an investment adviser.

This may also apply to people who issue or distribute securities reports or analysis to US customers either in return for compensation or as part of a normal course of business.

While the need to register may be clear in the case of traditional separately managed account (SMA) advisory relationships with US customers, there are other less obvious cases where it applies such as:

- **Robo-advisors:** These are a relatively new class of automated investment advisers that provide advisory services to retail investors through online platforms. In general, these platforms gather personal background and investment profile information from their users, generate investment recommendations using algorithmic programs, and in some cases even implement the recommendations on a discretionary basis. These platforms are designed to enable the deployment of sophisticated investment algorithms to retail investors at a cost significantly lower than traditional advisory

services. While business models vary, some robo-advisory platforms keep the costs low by providing limited or no human interaction with their customers.

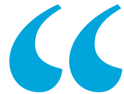
The SEC has clearly articulated its view that the substantive and fiduciary obligations of US investment adviser regulations apply to robo-advisers. Non-US-based providers of robo-advisory platforms should therefore be aware of these requirements and consider whether they need to register with the SEC if their platforms accept US customers.

- **Private Fund Advisers:** The introduction of financial reforms in the Dodd-Frank Act in July 2010 forced many more private fund advisers to register with the SEC as investment advisers. Previously, advisers to private funds (such as hedge funds, venture capital funds, private equity funds, etc.) were granted an exemption as long as they advised 15 or fewer funds. Under Dodd-Frank, exemptions from full SEC registration only apply to advisers focused purely on venture capital funds, or those who focus solely on private funds with less than US$150 million of assets under management in the US.

  The registration requirements for private fund advisers are not limited to advisers with operations in the US. Non-US-based private fund advisers may be subject to registration requirements if the private funds they manage have more than 15 US investors or more than US$25 million in assets under management attributable to US investors. Non-US private fund advisers who wish to avoid SEC registration must therefore monitor their private funds to ensure they do not exceed these limits.

Sponsoring electronic trading platforms

Electronic platforms enabling the issuance and trading of various types of financial instruments have proliferated in recent years. These platforms began with online access to traditional brokerage services, and have evolved to include the provision of trading in all types of securities and derivatives, direct investing in start-up companies and venture capital funds and, most recently, trading in digital virtual coins and tokens.



If an electronic platform permits the trading of securities and accepts US customers, the provider of the platform may be required to register with the SEC

Because these platforms are offered via the internet, they are not subject to any physical or geographical boundaries and typically may be accessed by customers in multiple jurisdictions.

If an electronic platform permits the trading of securities and accepts US customers, the provider of the platform should consider whether it is required to register with the SEC as a broker. For some platforms, the determination of whether they trade securities as defined under US law is clear: Instruments such as common and preferred stock, notes and bonds, and interests in private funds are generally within the definition of securities. Other platforms may require a more nuanced analysis. For example, platforms that facilitate the trading of interest in loans or real estate may or may not trade securities, depending on the exact characteristics of each instrument.

The newest frontier of this analysis deals with whether digital coins and tokens are defined as securities. The SEC has determined that at least some instruments sold in Initial Coin Offerings (ICOs) and Token Sales are securities, while the US Commodities Futures Trading Commission has stated that some may be commodities.

Until US regulators provide additional clarity regarding the regulatory treatment of different types of coins and tokens, operators of platforms that accept US customers and facilitate the purchase and sale of virtual coins and tokens that are similar to those that have already been classified as "securities" should consider whether they are required to register as brokers (and register their platforms as "alternative trading systems").

Approaching US investors through third parties

Non-US securities firms often seek to approach US investors through third parties to avoid triggering broker registration obligations. This strategy may be implemented successfully by complying with SEC Rule 15a-6, which generally requires that transactions be "chaperoned" by a US-registered broker-dealer. However, some non-US securities firms may wish to dispense with the chaperoning requirement and hire a so-called "finder" to introduce US customers.

If a firm decides to appoint a finder, it must ensure the finder is properly registered in the US or run the risk of regulatory enforcement and sanctions. This was the case for a private equity firm and one of its senior executives when they were charged by the SEC with hiring an unregistered finder. The firm and its executive paid civil penalties, and the executive was barred from the securities industry for their roles in aiding and abetting the unregistered broker's violation of the US securities laws.

US$25m

Threshold for US assets under management that triggers the need for non-US private fund advisers to register with the SEC

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CFPB models softer face in Mulvaney makeover

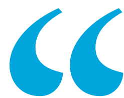
An overhaul of the Consumer Financial Protection Bureau by its acting head has ruffled feathers and heralded a less aggressive enforcement regime.

Since his appointment by President Trump in November 2017 as interim director of the Consumer Financial Protection Bureau (CFPB or Bureau), Mick Mulvaney has overseen sweeping reforms in the agency's structure and personnel as he delivers on his mandate to reduce the burden of regulation.

Mulvaney, who believes the CFPB—which was conceived to stamp out abusive consumer financial services practices after the financial crisis—is too powerful and has overstepped its statutory mandate, has instigated a dramatic overhaul during his brief tenure.

First, he introduced a layer of nine political appointees to serve in key positions, and recently disbanded three advisory boards: the Consumer Advisory Board, the Community Bank Advisory Council, and the Credit Union Advisory Council, in order to save on costs. The CFPB plans to reconvene the boards with fewer members in the fall.

Mulvaney has also announced plans to transfer the Office of Fair Lending and Equal Opportunity from the Division of Supervision, Enforcement & Fair Lending to the Office of the Director. As a result, the Office of Fair Lending and Equal Opportunity will no longer have fair lending supervisory authority, but rather will focus on advocacy, coordination and education. The Office of Students and Young Consumers, which has primarily investigated student loan abuses, will merge with the Office of Financial Education and instead focus on consumer education, including producing reports on the student loan industry and developing tools to assist students in navigating the process of paying college tuition.



Mick Mulvaney has overseen sweeping reforms in the agency's structure and personnel as he delivers on his mandate to reduce the burden of regulation

Lastly, Mulvaney has called on Congress to approve four reforms to the CFPB, namely:

1. to subject the CFPB to Congressional appropriations;
2. to give the President more oversight over the Bureau;
3. to create an independent inspector general for the CFPB; and
4. to subject all major, new CFPB rules to Congressional approval.

Mulvaney called on Congress to endorse the changes in order to increase the accountability of the CFPB and reduce bureaucracy: "[W]e need structural and legislative change to the way this place is being run."

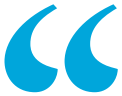
Enforcement

At the same time, Mulvaney has signaled a shift in tone, stating that the CFPB will no longer "push the envelope" and will dial down its previously aggressive enforcement approach. Under Mulvaney's watch, the CFPB has dropped a lawsuit against four payday lenders and dismissed the Bureau's case against PHH Corporation, following a decision from the DC Circuit resolving, in part, the legal battle over the interpretation of the Real Estate Settlement Procedures Act and the constitutionality of the CFPB's single-director structure.

By contrast, Attorneys General are expected to take the lead in enforcing consumer financial protection laws locally, while the CFPB will focus on the supervision and education of consumers regarding their financial protection rights. Relying primarily on consumer complaint data, the CFPB will focus its enforcement efforts to quantifiable and unavoidable harm to consumers. In addition, the Bureau is expected to dial back its use of the "unfair, deceptive or abusive acts or practices" provision (UDAAP) introduced under the Dodd-Frank Act as an enforcement tool.

The reassignment of the Office of Fair Lending and Equal Opportunity and Mulvaney's decision to tap the CFPB's reserves (instead of requesting funding) also appear to demonstrate a dialing down of the Bureau's enforcement efforts. The new CFPB leadership could use the Bureau's other initiatives, such as Project Catalyst and its No-Action Letter policy, to afford companies regulatory and enforcement relief—

Mick Mulvaney appointed interim director of the Consumer Financial Protection Bureau



The CFPB will now seek to reduce the regulatory burden for CFS-related activities, particularly rules introduced by the previous CFPB leadership under the Bureau's discretionary authority

Mulvaney has already announced that the CFPB is developing a regulatory sandbox for fintech companies in close cooperation with the Commodity Futures Trading Commission.

Rulemaking

According to its new mission statement, the CFPB will now seek to reduce the regulatory burden for CFS-related activities, particularly rules introduced by the previous CFPB leadership under the Bureau's discretionary authority. To that end, the Bureau intends to open new rulemakings to reconsider its payday, prepaid card and rules relating to the Home Mortgage Disclosure Act (HMDA). The new CFPB leadership may also seek to revisit the Bureau's previous significant rules as part of its five-year "look-back" assessments mandated by the Dodd-Frank Act. The Bureau is nevertheless expected to release a long-anticipated debt collection rule, given the sheer volume of collections complaints and the new leadership's focus on that metric.

Legislation

Changes to the CFPB's structure and supervisory authority are also looming, as lawmakers have sought to revamp the Bureau through the legislative process as well as subject its funding to Congressional appropriation. In December 2017, the Government Accountability Office (GAO) nullified a previous CFPB bulletin targeting dealer mark-ups using the disparate impact theory, which was recently rolled back by Congress under the Congressional Review Act.

Other proposed bills, currently in the US House or Senate, would impact many of the CFPB's core functions if passed, including its oversight of small-dollar loans, mortgage-related entities and consumer lending generally. Notably, the proposed Home Mortgage Disclosure Adjustment Act would exempt community banks, small credit unions and nonbank mortgage lenders from the expanded HMDA disclosure requirements. Lawmakers have also been actively trying to enable banks to issue high-interest payday loans (EQUAL Act), as well as to legislatively overturn the Second Circuit's decision in *Madden v. Midland Funding* to allow lenders to circumvent state interest caps. Finally, the Accountability of Wall Street Executives Act, introduced by certain Democrats, if passed, would permit state Attorneys General to issue subpoenas to investigate national banks. Other pending proposals have sought to revamp the Bureau's leadership structure by transforming it into a multi-member, bipartisan commission—an undercurrent present in recent, key federal cases.

Government Accountability Office (GAO) nullified a previous CFPB bulletin targeting dealer mark-ups

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Cracking the EU's NPL reforms

A package of reforms aimed at tackling non-performing loans will have far-reaching consequences for European banks.

In March 2018, the European Commission published a package of measures aimed at reducing the current stock of non-performing loans held by European banks and mitigating their build-up in the future. Separate guidelines on minimum regulatory provisioning levels for NPLs were published by the European Central Bank (ECB) through the addendum to its 2017 NPLs Guidance.

The new measures will have a significant impact on the NPL strategy of European banks, especially in countries with high NPL levels, but at the same time they will also affect the way in which lending is conducted and loans are collateralized and enforced in Europe.

NPL ratios may be falling across the EU, but the legacy stock of troubled assets and distressed loans of European banks is still one of the major impediments to a full economic recovery and increase of credit supply in some EU Member States. The total volume of NPLs in the EU is in the region of €910 billion, according to the European Commission.

Ratios diverge significantly across EU Member States. At the end of the third quarter of 2017, NPL ratios were close to 2 to 3 percent of total loans in a number of EU Member States (e.g. Belgium, Estonia, Germany and the Netherlands) or even lower in others (e.g. Luxembourg, Finland and Sweden). But in some of the countries that were most adversely affected by the financial crisis, NPL ratios are much higher—from between 10 percent and 15 percent in Ireland, Italy and Portugal, to a peak of 32.1 percent in Cyprus and 46.7 percent in Greece.

Over the past few years, the EU institutions have taken a number of initiatives to tackle NPLs. In July 2017, the European Council published an action plan to help reduce NPL levels and prevent their future build-up. In October, the commission issued a communication on the completion of the Banking Union and promised a package of measures designed to tackle NPLs in the spring. On March 14, 2018, the European Commission duly presented its package of measures, which comprised:

- A proposed regulation amending the Capital Requirements Regulation (CRR) regarding minimum loss coverage for non-performing exposures (NPEs)
- A proposed directive on credit servicers, credit purchasers and the recovery of collateral, which shall be transposed by Member States by December 31, 2020
- A blueprint on asset management companies (AMC)

Meanwhile, on March 15, 2018, the European Central Bank published the final version of its Addendum to the ECB Guidance to banks on NPLs.

Total volume of NPLs in the EU

Proposed regulation on NPL provisioning

Under the current regulatory and accounting framework, credit institutions enjoy a degree of discretion in determining NPE coverage levels. Such discretion has led to under-provisioning and loss forbearance in certain cases, as some credit institutions have adopted a "wait and see" approach in order to avoid or delay loss recognition—thereby reducing or postponing any negative impact on their common equity tier 1 (CET1) ratios.

The proposed regulation amendment will impose a "Pillar 1" minimum regulatory backstop for the provisioning of NPEs by EU banks. The minimum regulatory provisioning level shall be calculated by multiplying the value of each NPE by the factors indicated in the proposed regulation (see table 1).

The required provisioning level will depend on whether the NPE is past

Table 1: **EC minimum regulatory provisioning level (in %)**

	After year	1	2	3	4	5	6	7	8
Secured	Past due	5	10	17.5	27.5	40	55	75	100
	Non-past due	4	8	14	22	32	44	60	80
Unsecured	Past due	35	100	100	100	100	100	100	100
	Non-past due	28	80	80	80	80	80	80	80

Table 2: **ECB quantitative supervisory expectations (in %)**

After year	1	2	3	4	5	6	7
Secured	N/A	N/A	40	55	70	85	100
Unsecured	N/A	100	100	100	100	100	100

due or has been classified as NPE despite the fact that the institution still receives full payment from the debtor without excessive (i.e. 90-day) delay. It will also depend on the number of years after the date on which the exposure was classified as NPE, and whether the NPE (or part of the NPE) is classified as "secured" or "unsecured" exposure in accordance with the criteria specified in the proposed regulation.

Credit institutions will be allowed to meet the minimum regulatory requirement through provisions recognized under the applicable accounting framework and other eligible items indicated in the proposed regulation (including own funds reductions deriving from higher deductions applied by credit institutions). If such items are not sufficient to satisfy the minimum regulatory provisioning level required under the proposed regulation, the shortfall shall be deducted from the CET1 of the credit institution.

The above regime will only apply to exposures originated after March 14, 2018. However, where the terms and conditions of an exposure incurred prior to March 14, 2018 are modified by the institution in a way that increases its exposure to the debtor, the exposure shall be considered as having been incurred on the date of the modification and will fall under the new regime.

The proposed directive aims to remove the current impediments to the cross-border performance of credit servicing activities

ECB Addendum

The ECB Addendum indicates the non-binding supervisory expectations of the ECB in respect of the supervisory provisioning levels applied by "significant credit institutions" that are subject to the direct supervision of the ECB under the Single Supervisory Mechanism (SSM). These supervisory expectations will apply to all exposures classified as new NPEs after April 1, 2018. However, the compliance with such supervisory expectations will be assessed by the ECB only from 2021 onwards.

The approach taken by the ECB is very similar to that envisaged under the proposed regulation, but the minimum coverage levels required by the ECB (see table 2) are more stringent than those provided under the proposed regulation.

Compliance with the supervisory expectations indicated above will be assessed on a case-by-case basis by the ECB in the context of the supervisory review and evaluation process (SREP)—starting from 2021. If the ECB considers that the prudential provisions do not adequately cover the expected credit risk, supervisory measures under the Pillar 2 framework might be adopted.

Credit Servicers, credit purchasers and recovery of secured loans

Rules on Credit Servicers. The proposed directive looks to introduce a common framework for credit servicing activities, with a view to removing the current impediments to the cross-border performance of such services. Under the proposed directive, a credit servicer is defined as any natural or legal person (other than a credit institution or a subsidiary thereof) who carries out one or more of the following activities on behalf of a creditor:

- Monitoring the performance of the credit agreement;
- Collecting and managing information about the status of the credit agreement, of the borrower and of any collateral used to secure the credit agreement
- Informing the borrower of any changes in interest rates, charges or payments due under the credit agreement

Table 3: **Summary of the main differences between the EC proposed regulation and ECB addendum**

	EC Proposed regulation	ECB addendum
Nature	Binding EU regulation.	Non-binding supervisory expectations.
Scope of application	All credit institutions established in EU Member States.	Significant institutions subject to direct ECB supervision within the SSM.
Affected NPEs	Exposures originated after March 14, 2018.	NPEs classified as such after April 1, 2018.
Entry into force	The proposal shall follow the EU ordinary legislative procedure and its ultimate content and the date of entry into force are still uncertain.	The ECB Addendum does not require any further implementation. However, banks will be asked to inform the ECB on any differences between their practices and supervisory expectations from early 2021 onwards within the context of the SREP.
Approach	Pillar 1 minimum requirement.	Pillar 2 approach—i.e. supervisory dialogue and analysis of bank-specific circumstances to be incorporated into SREP decisions.
Non-past-due exposures	Different coverage levels between past due exposures and other NPEs.	No distinction between past due exposures and other NPEs.
Coverage levels	Less stringent calendar over an 8-year period.	More stringent calendar over a 7-year period.
Treatment of shortfall	Automatic deduction from CET1.	Pillar 2 measures adopted on a case-by-case basis.

- Enforcing the rights and obligations under the credit agreement on behalf of the creditor, including administering repayments
- Renegotiating the terms and conditions of the credit agreement with borrowers, where they are not a "credit intermediary"
- Handling borrowers' complaints

The definition is broad in scope and will likely capture a number of services and activities that are currently not subject to specific regulation in some EU Member States. Under the proposed directive, credit servicers operating on behalf of a credit institution or a credit purchaser in respect of a credit agreement issued by an EU credit institution (or its EU subsidiaries) shall be authorized to operate as such by the competent authorities of their home Member States.

The license granted under the proposed directive will allow credit servicers to operate on a cross-border basis under the right of establishment or freedom to provide services in accordance with the customary principle of EU financial law.

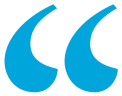
The proposed directive also specifies certain requirements applying to credit servicers, including with respect to the content of the credit servicing agreement, the record-keeping obligations and the outsourcing of services to third parties.

Rules on Credit Purchasers. The proposed directive encourages the development of a secondary market for NPLs by introducing common rules for credit purchasers—which includes any natural or legal person purchasing a credit agreement in the course of its trade, business or profession. These new rules will apply to cases where the credit agreement was issued by an EU credit institution (or by its EU subsidiaries) and the credit purchaser assumes the creditor's obligations under the credit agreement. The provisions of the proposed directive will not apply to the purchase of a credit agreement by an EU credit institution (or its EU subsidiaries).

Each creditor must provide the credit purchaser with all information necessary to assess the value of the credit agreement and the likelihood of recovery prior to entering into a contract for the transfer of the credit agreement. Certain information duties towards competent authorities are then provided in relation to credit purchasers.

Credit purchasers that are not domiciled or established in the EU shall designate in writing

Average NPL ratio in EU (Q3 2017)



One of the key goals of the proposed directive is to facilitate the recovery of secured loans through accelerated extrajudicial enforcement procedures

a representative who is domiciled or established in the EU to ensure compliance with the new rules. The designated representative will then appoint a credit institution (or a subsidiary) established in the EU, or an authorized credit servicer to perform credit servicing activities in respect of credit agreements concluded with consumers.

Rules on Out-of-Court Recovery of Secured Loans. One of the key goals of the proposed directive is to facilitate the recovery of secured loans (thereby reducing the risk of NPLs stock-piling) through the introduction of accelerated extrajudicial enforcement procedures. Such enforcement mechanisms may be used by creditors in connection with secured credit agreements entered into with borrowers that do not qualify as consumers (or non-profit-making companies).

The possibility to use the accelerated out-of-court enforcement procedures is subject to a number of conditions, including that the mechanism must be agreed in writing. The enforcement of the collateral can be made through a public auction or private sale. After the enforcement of the collateral, the creditor must pay the business borrower any positive difference between the proceeds of the sale of the asset and the sum outstanding under the secured credit agreement.

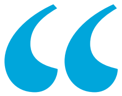
The business borrower may challenge the use of the these mechanisms before national courts where the sale of the assets provided as collateral has not been conducted in accordance with the rules set forth in the proposed directive.

The ACM blueprint

In essence, the AMC blueprint is a summary of the guidelines given and practice followed by EU institutions when dealing with State Aid cases in the banking sector during the last decade, particularly with respect to the use of publicly sponsored AMCs

Table 4: **Possible scenarios**

Purchase at market value	No State Aid or extraordinary public financial support pursuant to the bank recovery and resolution directive (BRRD) is granted, and the transfer of NPLs to the AMC is consequently not subject to EU State Aid and bank resolution framework.
Resolution	If the bank holding the impaired assets is under a resolution entailing State Aid or support through the resolution fund in accordance with the BRRD/SRMR rules, the AMC operates as the "bad bank" (asset management vehicle) in the context of the resolution. The use of the AMC—including as regards the valuation and transfer of impaired assets—is governed by the applicable resolution framework and the tool is ultimately managed by the resolution authority.
National insolvency proceedings	If the bank is not resolved but rather liquidated, NPLs can be transferred to AMCs as a form of State Aid in the context of national insolvency proceedings, provided that the principles of the State Aid framework are complied with. In this case, the relevant Member State is in charge of the management of the AMC.
Precautionary recapitalization	Precautionary recapitalization can be used in the specific case of a transfer of impaired assets to a publicly supported AMC, where the objectives pursued by such a transfer are the same as in the case of direct capital injection, and provided that the specific State Aid conditions for impaired asset measures are also respected.



The strengthening of NPLs coverage levels might induce EU banks to adopt a more prudent approach in their lending strategies

to clean up the balance sheet of credit institutions.

The blueprint does not innovate the current EU legal framework, but rather clarifies that AMCs can be used as an exceptional tool provided that the restrictions deriving from EU State Aid rules and the applicable resolution framework are complied with. Based on such legal and regulatory constraints, the AMC Blueprint identifies different scenarios where AMCs can be used (see table 4).

The AMC blueprint sets out the principles that should govern the design and set-up of publicly supported AMCs, their effective operations and disposal strategies, as well as the closing of the AMCs—which shall be established for a temporary period of time.

Change is coming

The combined effect of the EC and ECB measures and the entry into force of IFRS 9 may create incentives for EU banks to abandon the "wait and see" approach. The banks may sell their NPL portfolios in view of the forthcoming application of the minimum supervisory coverage requirements (and, for SSM significant banks, the ECB quantitative supervisory expectations on NPL coverage levels). Member States will be allowed to use national AMCs to support such processes, even though the current limits deriving from EU State Aid and the resolution framework are neither lifted nor amended under the AMC Blueprint.

The package proposed by EU institutions could also force EU banks to review their credit policies to incorporate the prospective impacts of NPL provisioning. It is yet to be seen whether this review will be beneficial and actually increase credit supply to SMEs—which is one of the goals underpinning the EC proposals. Indeed the strengthening of NPL coverage levels might induce EU banks to adopt a more prudent approach in their lending strategies, over-collateralize their loans or immediately enforce their claims as soon as the borrower becomes non-performing.

The proposals on the prudential backstop for NPL provisioning fail to recognize the existence of significant differences among EU Member States with respect to the average duration of debt recovery procedures. To a certain extent, European institutions are betting on the effectiveness of out-of-court accelerated enforcement procedures and other legislative proposals on debt restructurings to overcome these national differences. But the "one-size-fits-all" approach enshrined in the NPL provisioning calendar could ultimately result in an unlevel playing field for the internal market and the EU Banking Union, due to the different judicial systems and efficiency of national bankruptcy and enforcement procedures.

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