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Sale of Non-Performing Loans to Investment Funds: Benefits to banks and consumer protections

Introduction:

A bank loan is considered non-performing when more than 90 days pass without the borrower paying the agreed instalments or when there are indications that the borrower is unlikely to repay the loan. In order to resolve Non-Performing Loans (NPLs), banks basically have two options, either to restructure these loans or dispose of them from their balance sheets.

- Restructures can be done internally with special teams or by using external help and partnerships.
- Under the disposal option, banks can sell NPLs to a national asset management agency (such as NAMA), sell to third party private investors or securitise NPLs by transferring them to a special purpose vehicle and sell tranches of securities to external investors

As outlined by the European Central Bank (ECB), there are a number of reasons why banks should dispose of and not continue to hold NPLs, once stocks reach a critical mass.

- NPLs can tie up scarce bank resources including capital, funding and human resources diverting them from their main task of financing the economy;
- Large NPL stocks may impact bank funding costs, as a result of uncertainty surrounding the future prospects of the institution;
- NPLs increase the running costs of a bank and decrease profitability.

At an Institute of Banking briefing on the Irish mortgage market in June 2018, Ed Sibley, Deputy Governor of the Central Bank of Ireland (CBI) stated that portfolio sales are a legitimate and necessary approach for banks to use to address non-performing mortgage loans. He further emphasised that the CBI, with the support of the Oireachtas, has ensured that the protections of our Codes of Conduct including the Code of Conduct on Mortgage Arrears travel with the loans.

Banks in Ireland have made significant progress in reducing their NPL ratios, from 14.6% of total loans in June 2016 to 5% of the total in March 2019 according to latest available European Banking Authority (EBA) data. In addition to the reduction in the NPL ratio on their balance sheets, banks in Ireland have, utilising internal workout units, restructured significant number of loans in arrears; around 117,000 mortgage accounts were categorised as restructured at end-March 2019 according to CBI data, of which 86 per cent were deemed to be meeting the terms of their arrangement, on average.

European Commission implementing regulations as well as EBA supervisory reporting requirements define clear rules as to how a restructured loan becomes a performing loan. This process can take around three years from the original restructuring agreement with application of strict rules around the agreement.

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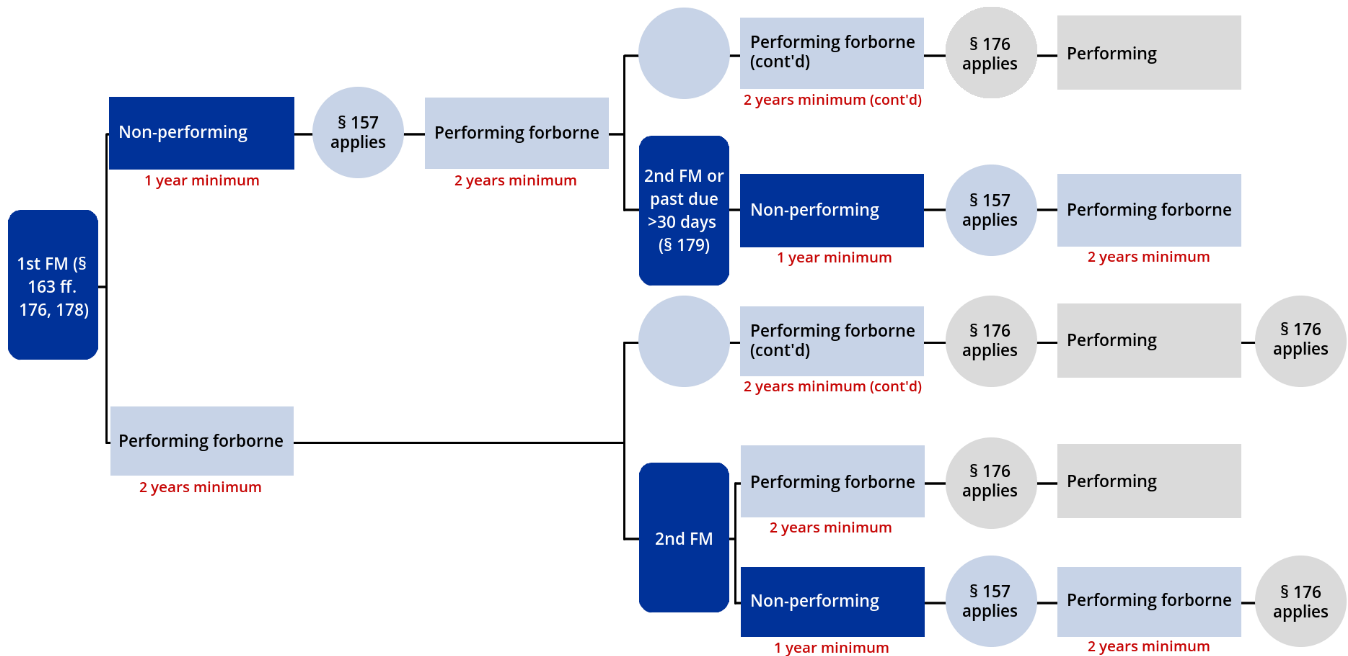

Forbearance measures (FM)

From non-performing to Performing forborne

From performing forborne to Performing

Sources and notes of the figure: All paragraphs refer to Annex V, Part 2, Regulation (EU) 680'2014

§ 157
- ✔ 1 year since forbearance measures
- ✔ No past-due amounts following forbearance measures
- ✔ Payments of amounts previously past-due or written-off
- ✔ No other transaction non-performing (when non-performing status assessed on a debtor basis, para. 154-155)

§ 176
- ✔ Mimimum 2 year probation period since performing status
- ✔ Regular payments of more than an insignificant aggregate amount of interest principal over at least 1 year
- ✔ No other transaction past due >30 days

Particularly in the last two years, banks have started using the option of selling NPL portfolios in order to reduce the level of NPLs to a sustainable level in line with their NPL reduction plans agreed with the ECB Single Supervisory Mechanism (SSM). These plans were initially prepared by banks and approved by the SSM and banks were asked to comply with the targets in the plans or explain divergence which can lead to supervisory capital add-ons. In addition to the supervisory expectations, the European Council set out an action plan for reduction of non-performing loans in the European banking sector in 2017. The plan includes actions under supervision, reforms around insolvency and debt recovery frameworks and development of secondary markets for NPLs. As part of the action plan, regulations amending the Capital Requirements Regulation (CRR) which require banks to have sufficient loan loss coverage for newly originated loans were adopted in April 2019. A Directive on credit servicers, credit purchasers and the recovery of collateral was proposed by the EC and the Council reached a partial general approach regarding secondary markets, while negotiations regarding the recovery of collateral are ongoing and it is expected that the new Parliament will work on this file as a priority. According to the latest data from the CBI, as of March 2019, non-bank entities hold more residential NPLs compared to banks in Ireland, €5.9 billion in banks vs. €7 billion in non-bank entities.

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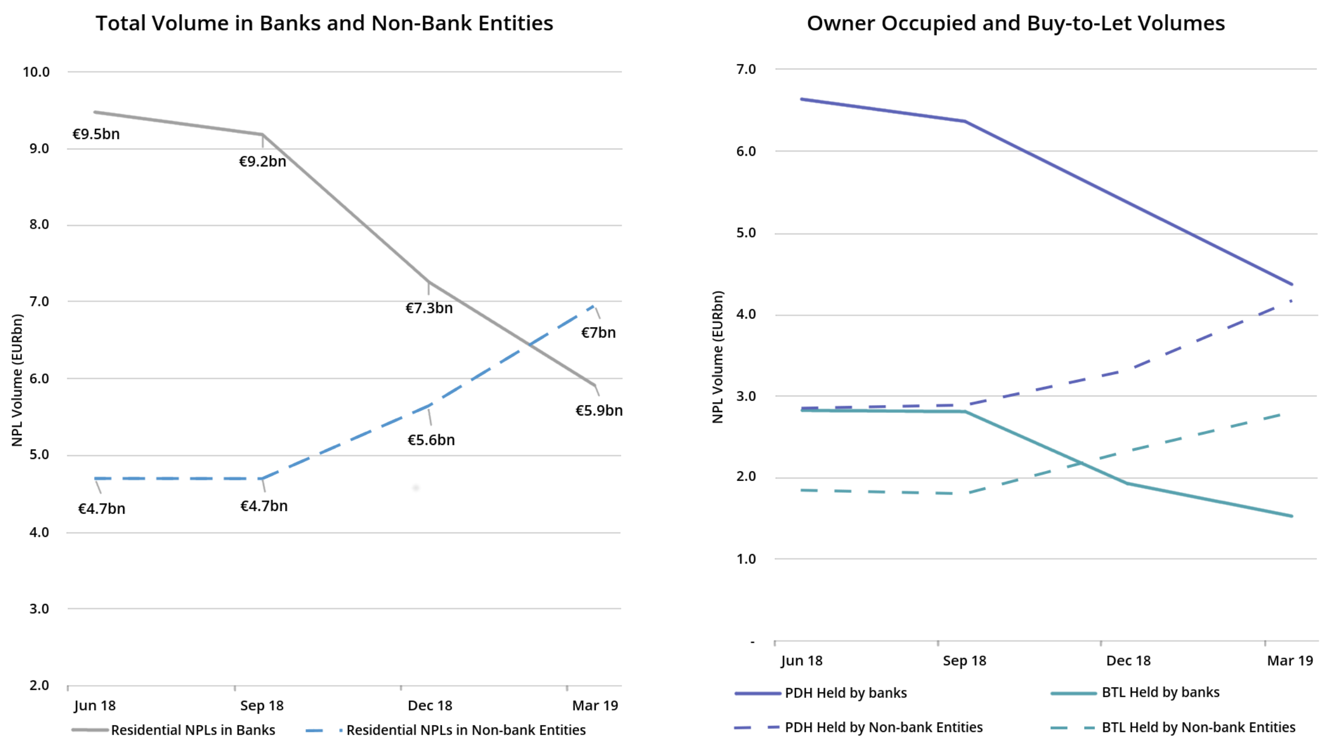
Volume of Residential NPLs in Banks and Non-Bank Entities



PDH = Primary Dwelling Homes; BTL = Buy-to-Let

Source: Central Bank of Ireland

Recent figures on mortgage arrears from the CBI show that:

- Out of 726,089 private residential mortgage accounts for principal dwellings held in the Republic of Ireland, 43,643 (6%) accounts were in arrears of more than 90 days

- There were 27,979 accounts in arrears over 720 days, accounting for 45 per cent of all accounts in arrears at end-March 2019, and at €2.4 billion, represented 88 per cent of arrears balances outstanding.

Banks' approach to using securitisation as a solution rather than selling loans

Capital requirements and provisioning rules are not the same for banks and investment funds and hence pricing of securitisation deals may work out more expensive for banks compared to these funds if they were to follow this route. Experience from recent securitisation transactions involving NPLs show that banks invest on either senior or junior tranches of the securitised portfolio in addition to providing funding to the buyers, which leads to these transactions becoming more complex and costly compared to direct sale of portfolios. However, there has been two examples of this solution recently, one involving split mortgages and the other for the BTL portfolio and it is likely that we may see more solutions provided through securitisation deals in the near future.

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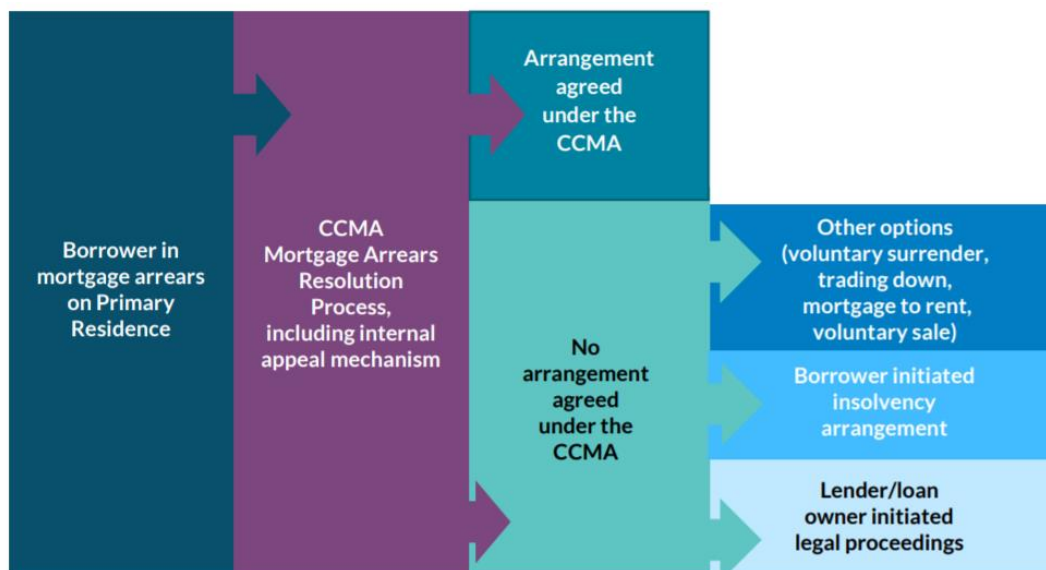
The Facts on False Claims

Claim: Borrowers do not have the same protection when their loans are sold on by banks

Fact: Borrowers do have the same protection

In July 2015, the Consumer Protection Act 2015 came into effect which ensured that relevant borrowers whose loans are sold to investment funds are afforded the same regulatory protection they had prior to the sale, including those provided for by the CBI's Consumer Protection Code (CPC) 2012 and the CBI's Code of Conduct on Mortgage Arrears (CCMA). The protections available to the borrower travel with the loan in all cases, along with loan contract terms and conditions, regardless of whether the borrower has an arrangement in place or not.

Mortgage Arrears Resolution Process (MARP) in Ireland



Source: CBI

When an investment fund buys a loan, that loan must be serviced by a bank, a retail credit firm (RCF) or a credit servicing firm (CSF), which is authorised and regulated by the CBI to act on their behalf in applying the protections of the CPC and the CCMA to the mortgage.

Even before the above-mentioned amendments to the Consumer Protection Act in 2015, retail credit firms and credit servicers were following the MARP framework and the CCMA.

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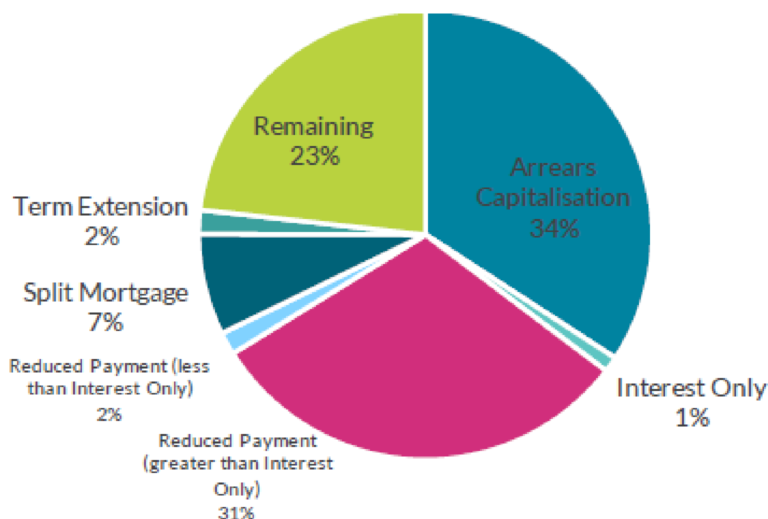
Claim: Investment funds do not offer to borrowers forbearance measures similar to those from banks

Fact: Investment funds do provide a wide range of forbearance measures to borrowers

Where a loan is sold to an investment fund, existing arrangements with borrowers are honoured until the agreed term of the arrangement comes to an end. Borrowers may then be offered a different arrangement within the MARP framework. Below is a chart from a Central Bank of Ireland (CBI) study published in October 2018, showing different options utilised by investment funds and banks for restructuring arrangements.

The Central Bank data shows that as at end Q1 2018, banks were considering, on average, nine arrangements within their suite while investment funds were considering 13 on average. However, the data gathered also shows that for the period Q1 2016 to end Q1 2018, banks and RCFs put in place a broader range of arrangements than investment funds. Based on the same data set, banks put in place a 50/50 split between short-term and long-term arrangements. RCFs put mostly long-term arrangements in place, while two-thirds of the arrangements put in place by investment funds were short-term.

Type of Arrangements Offered by Investment Funds



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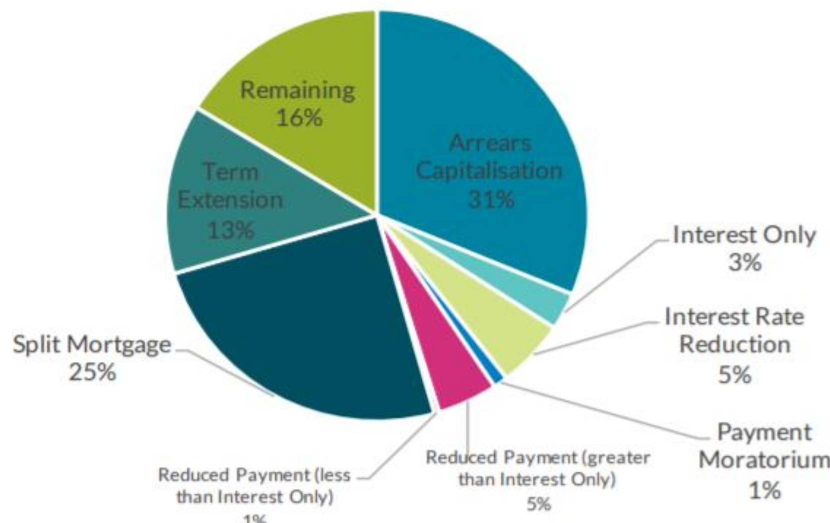
Type of Arrangements Offered by Banks



Most investment funds' business models rely on bringing non-performing loans back to performing status through Alternative Rearrangements similar to what banks offer and use these loans for securitisation. These securitisation deals can involve banks or other institutional investors such as pension funds on the buy side.

Claim: Ireland is facing a "tsunami of repossessions"

Fact: Repossessions here are low by international standards

As widely agreed by various observers , the repossession process in Ireland is a lengthy and costly, hence this type of solution goes against the business model of investment funds in terms of providing an affordable and sustainable restructuring arrangement with the borrower with a view to getting a non performing loan back to performing status so that securitisation arrangements can be implemented. Repossessions are used as a last resort. Our courts process provides protection to borrowers over and above that available in many other jurisdictions. According to Standard & Poor's, the full legal process for repossession can typically take as long as 42 months in Ireland, considerably longer than in other European countries such as the UK (18), Denmark (18), Norway (18), Sweden (18), Finland (24), The Netherlands (24), Austria (30) and Germany (30), for example.

Recent CBI data show that during first quarter of 2019 non-bank entities repossessed 30 PDH properties and the total number of repossessed PDH properties by non-bank entities stood at 365.

A total of 127 properties were taken into possession by banks during the first quarter of 2019, of which 89 were voluntary surrender. Lenders were in possession of 1,441 PDH properties at end-March 2019.

According to Central Bank data, since Sept 2009 a total of 9,507 have lost possession of their homes – 3,142 (33%) by court order and 6,365 (67%) by voluntary surrender. Data from the Courts Service shows a fall in repossession applications to the courts – at the very time when portfolio sales to funds have been increasing. At the same time around 117,000 mortgage accounts were categorised as

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restructured at end-March 2019 according to CBI data, of which 86 per cent were deemed to be meeting the terms of their arrangement, on average.

Claim: Investment funds do not facilitate arrangements for borrowers

Fact: Investment funds do put arrangements in place for borrowers

Many of the funds operating here are staffed by personnel who have extensive UK-market experience of pro-actively dealing with and fixing problem loans. In order to provide a long-term sustainable solution for their customers, investment funds use many repayment arrangements within the MARP framework.

In terms of the rates they charge these are similar to the market rates observed. In addition, ULOs seem to be able to offer longer term fixed rates to customers on a competitive basis perhaps due to current low interest rate environment, which leads to security for the occupiers and higher fixed income option for bond buyers.

Investment funds also get involved in Personal Insolvency Arrangement (PIA) where a sustainable long-term solution can be found. In addition, they work with the companies in the market that provide Mortgage to Rent solutions for customers in difficulty. Since the involvement of ULOS through the secondary markets, there has been an increase in the number of customers that have used mortgage to rent as a sustainable solution. As of end of June 2019, a total of 4712 cases have been submitted under the MTR scheme where 527 cases were completed, 1058 actively being progresses, 3127 were ineligible or terminated during the process, of which 306 cases were not progressed because the household in question was deemed to be over or under accommodated and agreement on the sale could not be reached on a further 98 cases.

Conclusions:

- Banks in Ireland have made significant progress in reducing their NPL ratios in the past two years, with various resolution tools including sale of NPLS portfolios
- During this process, borrowers are fully protected.
- However, progress is not helped by misleading claims.
- Funds that buy NPL portfolios provide arrangements to borrowers similar to ones provided by banks.

6 September 2019