Brussels, 16 June 2016

EMF Response to the European Commission's Consultation on an Effective Insolvency Framework within the EU

Question 1.1 Which measures should be taken to achieve an appropriate insolvency framework within the EU?

In the first instance, we would like to explain that the primary focus of the European Mortgage Federation (EMF)[1] is residential mortgage lending and therefore secured creditors. For this reason, we have limited our responses for the most part to those questions which have a direct relevance for the mortgage industry.

- We support the efforts to ensure the existence of effective insolvency frameworks for business in EU Member States. With this in mind, the elements (except (d) – see below for further explanation here) mentioned in question 1.1, could potentially have a role to play in the design of such a framework for businesses.

- However, it should be borne in mind that the design/calibration of these individual measures is very challenging as they are often closely inter-linked with other legal regimes in Member States, as well as the economic, social and employment conditions of a Member State. For this reason, any intervention at EU level should be sensitive to national specificities, as well as existing Member State legislation, which in many cases has been very recently reformed.

- In any case, we strongly believe that measures to ensure discharge of debt for consumers **should not** form part of the efforts of this consultation to create an efficient insolvency framework for businesses. In general, EU legislation as well as national legislation in many areas (e.g. investments and credits) distinguishes between consumers and professionals. Over-indebtedness for consumers is not the result of the same mechanisms as for businesses, the nature and scale of the over-indebtedness is very different, and, as such, the solutions should be different. The case of consumers requires a different focus than businesses and should be left out of this consultation.

Question 1.2 To what extent do the existing differences between the laws of the Member States in the areas mentioned below affect the functioning of the Internal Market?

Differences between Member States' insolvency frameworks can act as an obstacle to the free movement of capital, goods and services and the functioning of Internal Market. The unpredictability of insolvency proceedings can make it difficult for creditors to recover the value from distressed debts, which in turn can contribute to high levels of non-performing loans. The latter weight on a bank's balance sheet as a consequence may lead to constraints in its lending activities. Moreover, this unpredictability could act as a deterrent to cross-border corporate investment, since the difficulties of

[1] Established in 1967, the European Mortgage Federation (EMF) is the voice of the European mortgage industry, representing the interests of mortgage lenders and covered bond issuers at European level. The EMF provides data and information on European mortgage markets, which were worth over €6.7 trillion at the end of 2013. As of February 2015, the EMF has 18 members across 14 EU Member States as well as a number of observer members. In 2004, the EMF founded the European Covered Bond Council (ECBC), which is a platform that brings together covered bond market participants. The EMF-ECBC is registered in the EU Transparency Register under ID Number 24967486965-09.

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establishing the value of distressed debt could increase the cost at which investors are willing to invest and even discourage investors from establishing their business activities in other Member States at all.

We would like to take this opportunity to underline, however, that the harmonisation of insolvency proceedings is only one element which could potentially strengthen the Single Market.

Question 2.4 When should debtors have access to a framework of restructuring measures enabling them to restructure their business/liabilities?

Restructuring measures are only possible before the debtor is insolvent and where there is likelihood of imminent insolvency. During the pre-insolvency phase, debtors should have the possibility to contact creditors to agree on debt relief.

Question 2.4.1 Should such restructuring measures always require, at some stage, the opening of some sort of a formal procedure in which a court (or other competent authority or body) is involved?

During pre-insolvency proceedings debtors and creditors have the possibility to find an agreement on debt relief. In some jurisdictions, the legislation provides for alternative restructuring procedures (out-of-court payments agreements) where there is no involvement of courts; these systems have proved to be flexible and effective in practice. But whenever creditor's rights are affected a court should be involved in order to avoid any interference with creditor's rights.

We see merit in formal procedures supervised by a court which can offer (i) transparency, (ii) control of the insolvency practitioners/mediators/supervisors, (iii) accessible information, (iv) respect of a limited length of the procedure, (v) the intervention of an external, independent and neutral body to supervise and drive the restructuring process and (vi) protection for creditors that brought new money and/or took new guarantees.

However, in order to enact enforcement actions (moratorium) or to confirm a plan, a decision of a relevant court is required.

Question 2.10 Should a restructuring plan adopted by the majority of creditors be binding on all creditors provided that it is confirmed by a court?

Often credit is offered against a collateral (e.g. a mortgage or another comparable security) thereby giving access to cheaper financing of a business for the entrepreneur. In such cases an effective access to enforcement of the collateral in case of default on the loan is essential. If insolvency proceedings are inefficient, lengthy and costly or the design of the law limits the creditor's control over the collateral it will increase the cost of lending and limit access to credit for business.

For some types of financing, the access to the collateral is inherently linked to the conditions of the loan. This is true, for example, for loans financed by covered bonds and offered against registered collateral. The collateral forms part of the covered bond investors' protection in case of default of the

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underlying loan (e.g. mortgages). The direct claim of the creditor on the collateral in case of default is essential to ensure the security of covered bonds.

Additionally, the enforceability of the collateral is a fundamental prerequisite for the preferential risk weighting of mortgages for the calculation of banks' capital requirements under the Capital Requirements Regulation (CRR/CRD IV). Any moves to limit the lenders' ability to enforce its claim over the collateral would have serious implications for banks' capital requirements, their funding costs as explained above, and over-collateralisation requirements from rating agencies.

Currently, depending on the jurisdiction, a restructuring plan can be agreed: 1) out of court by creditors (scheme of arrangements), in which case it is binding only on those participating in the agreement; 2) in formal court proceedings, in which case it may be binding on those creditors who do not participate in the court proceedings. It is our view that secured creditors should not be affected by any restructuring plan agreed without their participation, unless they agree subsequently to be bound by it.

In any case, it is our view that there should be no change to the hierarchy of claims. Preventive procedures can affect only those who participate in them and agree to the outcome and cannot bind others. The plan can be brought to a court for approval only if there is a trigger: possibly problems with liquidity. The plan could be confirmed by the court only if those who have not participated in the agreement have their views respected.

Finally, in accordance with paragraph 17 of the 2014 Recommendations i.e. "creditors with different interests should be treated in separate classes which reflect those interests", in case the majority's plan is confirmed by a court and confirmed as binding on others creditors, it should be clearly understood as binding on the other creditors in a given rank/class only. Different ranks/classes have different majorities.

Question 3.1 Should honest debtors (entrepreneurs and consumers) who are over-indebted be offered the chance to restructuring their debt?

In our view, full debt discharge may be counterproductive, since it does not promote a responsible entrepreneurship model. Therefore we advocate debt discharge only when a certain amount of a debt is repaid.

For consumers' insolvency see our answer to the question in 1.1.

Question 3.3 Should a full discharge of debts, possibly subject to certain conditions, be offered to all over-indebted individuals provided they are 'honest' debtors?

In our opinion, full, unconditional debt discharge could present a moral hazard, because it would not promote responsible entrepreneurship. We therefore advocate that honest entrepreneurs that have experienced bankruptcy should be discharged from such debts after a relatively short period of time, only provided that they repay a certain amount of debt.

Question 3.3.2 What should be the maximum discharge period for honest debtors who cannot repay their debts (in other words, what should be the period after which such debtors would be completely discharged from debt, as long as they meet the obligations

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imposed by national laws)?

Discharge should only be granted to debtors who have settled their debts at least in part, and never indiscriminately. This would ensure a proper balance between the debtor's interests and the creditors' right to repayment.

A balance between the rights of creditors and the interests of the debtor and the potential benefits of a second chance for the wider economy must be achieved in order to ensure that, at the end of the day, there are actually benefits for all parties involved – otherwise creditors, for their part, would become more cautious and access to finance, for example, would be restricted (higher interest rates, more security/guarantees required), which might well lead to the elimination of the potential benefits to the wider economy resulting from the second chance policy. The establishment of a minimum of debt that has to be paid by the debtor irrespective of the discharge period that has elapsed may be a valuable instrument to provide some certainty and security to the "creditor-side" of the balance.

Question 3.3.4 Which special types of debt should be excluded from discharge? *(choose all that apply)*

X a) Tort claims

X b) Fines

X c) Child support

☐ d) Tax and other public liabilities

☐ e) Other types of debt

☐ f) No opinion

Question 4.3 Which claims should have priority in insolvency proceedings (i.e. be satisfied first from the proceeds of the insolvent estate)? (choose all that apply)

Often credit is offered against a collateral (e.g. a mortgage) thereby giving access to cheaper financing of a business for the entrepreneur. In such cases an effective access to enforcement of the collateral in case of default on the loan is essential. If insolvency proceedings are inefficient, lengthy and costly or the design of the law limits the creditor's control over the collateral it will increase the cost of lending and limit access to credit for business.

For some types of financing, the access to the collateral is inherently linked to the conditions of the loan. This is true, for example, for loans financed by covered bonds and offered against registered collateral. The collateral forms part of the covered bond investors' protection in case of default of the underlying loan (e.g. mortgages). The direct claim of the creditor on the collateral in case of default is essential to ensure the security of covered bonds.

Secured creditors should be able to predict, with a high degree of certainty, which claims will rank above their own. This means that privileges should be regarded as very exceptional and be clearly stipulated in a legal provision. We believe that secured creditors should be exempted from restructuring plans agreed without their participation and unless they agree subsequently to be bound by it, and be satisfied before all other creditors to avoid negative impact on mortgage credit.

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