EUROPEAN CENTRAL BANK

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OPINION OF THE EUROPEAN CENTRAL BANK

of 29 March 2019

on requiring the consent of borrowers to transfers of loans secured by mortgages on residential property

(CON/2019/14)

Introduction and legal basis

On 4 March 2019 the European Central Bank (ECB) received a request from Chairman of the Oireachtas (Irish National Parliament) Joint Committee on Finance, Public Expenditure and Reform, and Taoiseach (Irish Prime Minister) for an opinion on a No Consent, No Sale Bill 2019 (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the third and sixth indents of Article 2(1) of Council Decision 98/415/EC[1], as the draft law relates to (a) the basic task of the European System of Central Banks (ESCB) to implement the monetary policy of the Union pursuant to the first indent of Article 127(2) of the Treaty, (b) the specific tasks conferred upon the ECB concerning policies relating to the prudential supervision of credit institutions pursuant to Article 127(6) of the Treaty, (c) the Central Bank of Ireland (CBI) and (d) rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

1.1 The draft law introduces a new rule to the effect that lenders may not transfer loans secured by the mortgage of residential property without the written consent of the borrower. It specifies that when seeking a borrower's consent to such a transfer, the lender must provide a statement giving sufficient information on how the transfer would affect the individual borrower so that the borrower may make an informed decision and be given a reasonable time within which to give or decline to give such consent. This statement of information must be approved by the CBI before it is provided to a borrower.

1.2 The draft law sets out the information that must be provided in the statement of information to a borrower, namely: (i) the name and address of the intended transferee, and of any holding company applicable; (ii) the relationship, if any, between the lender and the transferee; (iii) a description of the intended transferee and of its business, including how long it has been in operation, and details of its involvement in the management of mortgages; (iv) details of the

1 Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

policies and procedures which will apply for the setting of mortgage interest rates and for the making of repayments if the transfer takes place; and (v) confirmation that in the absence of a specific consent the existing arrangements will continue to apply.

1.3 The draft law also covers transfers in the context of securitisation-type transactions where the original lender would service the mortgage as an agent of the transferee. In such cases, the lender must confirm that the transferee's policy on handling arrears and setting interest rates will be the same as that of the original lender, and that the original lender will handle arrears as its agent.

1.4 The draft law also provides that where, following a transfer of a mortgage, the lender would no longer have control of setting the interest rates and/or determining the conduct of relations with borrowers seriously in arrears, the lender must seek the borrower's consent notwithstanding any previous consent the borrower has given. It also lays down certain requirements for any mortgage transfer agreement, including that a transferee must allow transferred mortgages to be redeemed without charging a redemption fee and must allow the borrower to arrange their own insurance.

1.5 The requirements of the draft law do not apply in certain limited cases, including where the lender is subject to winding-up proceedings, or has been determined by the CBI to be failing or likely to fail and the lender has satisfied the CBI that the application of the draft law would not be appropriate and that the transfer is being effected on terms which are just and equitable and which a borrower would reasonably be entitled to expect.

2. General observations

2.1 The ECB understands the draft law applies to the transfer of all loans secured by a mortgage of a residential property. While the draft law does not define the term 'residential property', the ECB understands that the draft law applies to both owner-occupied and rented or buy-to-let properties, regardless of whether the loan secured by the mortgage is classified as performing or non-performing. In addition, there are no restrictions on borrowers withholding their consent to a transfer; rather, borrower consent may be withheld in any and all circumstances. The ECB also understands that the draft law applies not only to the transfer of 'new' residential mortgages – entered into after the enactment of the draft law – but also applies to transfers of 'existing' mortgages – entered into prior to the enactment of the draft law.

2.2 The ECB understands that the draft law applies to all transfers of residential mortgages, without distinguishing between the purpose and the means of the transfer. The ECB notes that, under Irish law, in order for credit institutions to issue asset-backed securities (ABSs), covered bonds, or residential (or special residential) mortgage-backed promissory notes, or to create security over pools of credit claims, the underlying residential mortgages must be transferred or, in the case of a security interest, capable of subsequent transfer. The effect of the draft law would be to render the type of asset transfers required to utilise these financial instruments and techniques effectively impossible for Irish credit institutions. However, all of these instruments and techniques are essential, both in relation to performing and non-performing loans, for the funding and, thus the day-to-day functioning of the Irish banking sector. As such, the draft law would make the use of

Irish residential mortgages as collateral for bank funding significantly more difficult, if not impossible.

2.3 Moreover, the presence of significant volumes of non-performing loans (NPLs) on credit institutions' balance sheets reduces the ability of those institutions to fulfil their function as providers of credit to the real economy, and hampers the operational flexibility and overall profitability that are indispensable to a well-functioning banking sector. It is essential that the national legal framework enables the efficient transfer of NPLs off the balance sheet of credit institutions, through asset sales, securitisations and other measures.

2.4 The draft law is being introduced without the benefit of a thorough impact assessment. Only by making such a prior assessment would it be possible both to i) determine whether the draft law is able to achieve its aim – presumed to be consumer protection, and ii) mitigate any negative implications. However, in the absence of an impact assessment, it is difficult to be confident whether the objectives set by the draft law would be achieved[2]. Indeed, for the reasons outlined in this opinion, the ECB has concerns that the draft law would have significant adverse effects on Irish credit institutions' ability to participate in Eurosystem monetary policy operations, as well as on their funding situation and capacity to properly manage their balance sheets. In turn, this is likely to result in additional costs being passed on to other borrowers; it could also result in a significant impact on mortgage pricing and availability, and even an increase in NPLs, all of which are likely to impact financial stability, Irish taxpayers, and ultimately the Irish economy.

2.5 Finally, the ECB notes that it is not clear whether the draft law applies retrospectively to transfers of mortgages which took place prior to the enactment of the draft law. Hence, the draft law may raise issues of legal certainty in respect of the validity of such transfers.

3. Specific observations

3.1 *Access of Irish credit institutions to Eurosystem credit operations and effects on the transmission of monetary policy in Ireland*

3.1.1 In accordance with Article 18.1 of the Statute of the ESCB and of the ECB, the Eurosystem provides credit to eligible monetary policy counterparties, with lending based on adequate collateral. The types of assets which can be pledged as collateral in Eurosystem credit operations include marketable assets such as ABSs and covered bonds, as well as non-marketable assets such as credit claims, mortgage-backed promissory notes (MBPNs)[3] and additional credit claims (ACCs)[4].

3.1.2 The ECB notes that Irish credit institutions are heavily reliant on mobilising collateral backed by residential mortgages, in particular ABSs, covered bonds and ACCs, to access Eurosystem credit

2 See paragraph 2.2.2 of Opinion CON/2018/13, paragraph 2.3 of Opinion CON/2012/70, paragraph 2.3 of Opinion CON/2012/40, and paragraph 2.2 of Opinion CON/2010/34. All ECB opinions are published on the ECB's website at www.ecb.europa.eu.

3 Guideline (EU) 2015/510 of the European Central Bank of 19 December 2014 on the implementation of the Eurosystem monetary policy framework (ECB/2014/60) OJ L 91, 2.4.2015, p. 3.

4 Article 4 of Guideline 2014/528 of the European Central Bank of 9 July 2014 on additional temporary measures relating to Eurosystem refinancing operations and eligibility of collateral and amending Guideline ECB/2007/9 (ECB/2014/31) OJ L 240, 13.8.2014, p. 28.

operations. Such ABSs, covered bonds and ACCs are generally backed by performing residential mortgages, transfers of which are also affected by the draft law.

3.1.3 By requiring the written consent of the borrower for the transfer of a mortgage, the draft law would significantly reduce the possibility for Irish credit institutions to mobilise pools of residential mortgage loans under the ACC scheme as collateral in Eurosystem credit operations. Moreover, by materially restricting the issuance of residential mortgage-backed securities (RMBSs) and of covered bonds, it would also impede the ability of Irish credit institutions to generate collateral that could be pledged to access Eurosystem credit operations.

3.1.4 This potentially relevant reduction in the availability of collateral assets could limit the amount of central bank liquidity that Irish banks could obtain from the Eurosystem, both in the main refinancing operations (MRO) and in the long-term refinancing operations (LTRO). In this regard, the Eurosystem's fixed-rate full allotment policy has recently been extended until the end of the reserve maintenance period starting in March 2021[5]. Under this policy, eligible monetary policy counterparties can obtain the entire amount of liquidity requested from the Eurosystem. In this context, the availability of a sufficiently large amount of eligible collateral is crucial for credit institutions to be able to participate in Eurosystem credit operations and then to obtain the amount of liquidity they need. From the perspective of Irish credit institutions, and given that residential mortgages comprise a large proportion of their business, the draft law could therefore severely restrict their ability to access Eurosystem credit operations. This ability is of fundamental importance to credit institutions under normal circumstances, and is critical in times of financial stress. The inability of Irish credit institutions to generate mortgage-backed collateral would, de facto, also prevent Irish credit institutions from using mortgage-backed collateral for the purposes of accessing programmes under several of the Eurosystem's non-standard monetary policy measures, notably for purchases under the ABS purchase programme (ABSPP) and the third covered bond purchase programme (CBPP3). This is because the eligibility of an ABS or a covered bond under the Eurosystem's collateral framework is a necessary condition for determining its eligibility for purchase under the ABSPP and CBPP3.

3.1.5 By reducing the available types of collateral that can be charged by Irish credit institutions, the draft law could significantly limit the effectiveness in Ireland of monetary policy measures intended to ensure the smooth functioning of the monetary policy transmission mechanism, and thus, the achievement of the Eurosystem's primary objective of maintaining price stability. Such limitation on the effectiveness of monetary policy measures in Ireland could give rise to fragmentation across the euro area concerning the extent to which monetary policy measures are reflected in the funding costs of Irish banks and then – ultimately – in the interest rates charged to borrowers.

3.1.6 Moreover, to the extent that participation in Eurosystem monetary policy operations reduces the funding costs of credit institutions and increases their funding sources, impediments to making full use of those monetary policy tools would increase funding costs and decrease funding sources. Ultimately, this could also be reflected in increased interest rates charged to borrowers.

5 See ECB press release on monetary policy decisions dated 7 March 2019 (link).

3.2 *Implications for bank funding and lending conditions*

3.2.1 If, as a result of the effects of the draft law, Irish credit institutions could no longer reliably access Eurosystem credit operations, they would have to increase their market-based wholesale funding, either through short-term interbank borrowing or issuance of debt instruments. However, funding by way of debt issuance also relies, to some extent, on the ability of credit institutions to securitise performing and non-performing loans and to issue covered bonds to be sold to market investors. Since the draft law would effectively prevent any future issuance of securitisations or covered bonds, Irish credit institutions would need to issue a larger amount of unsecured bonds, which would be subject to less favourable pricing than secured debt instruments.

3.2.2 These factors would then contribute to an increase in the funding costs of Irish credit institutions, which may then be passed through to borrowers via an increase in interest rates. In addition, if credit institutions with reduced access to funding sources encounter difficulties in raising wholesale debt funding from the private market, this could, in turn, lead to capacity constraints in bank lending to the real economy more generally.

3.3 *Effects on the banking sector*

3.3.1 In the context of its direct responsibility for the supervision of significant banking groups within the euro area, the ECB closely monitors the stability of credit institutions. The high level of NPLs in Ireland has brought large credit losses to Irish credit institutions in the recent past. Thus, it is important that NPLs are dealt with in an efficient and effective manner – balancing, on the one hand, the need to ensure observance of the general duty of debtors to meet their payment obligations and, on the other hand, the need to provide assistance to individuals in dire financial situations[6]. Risk transfer through asset sales, securitisation and other measures is an important part of the toolkit available to credit institutions to reduce NPLs in an effective manner; these are in addition to other tools, such as the originating credit institutions' internal procedures for handling the work-out of NPLs.

3.3.2 Provided that the consumer protection framework remains fully applicable to transfers regulated by the draft law, borrowers should not be worse off in the event that their mortgage is transferred to a purchaser. In that respect, the ECB understands that borrowers currently benefit from the protections afforded to them under the CBI's Code of Conduct on Mortgage Arrears 2013 and the Consumer Protection Code 2012, as well as Part V of the Central Bank Act 1997 – as amended by the Consumer Protection (Regulation of Credit Servicing Firms) Act 2015 and the Consumer Protection (Regulation of Credit Servicing Firms) Act 2018 – which provides for the regulation of credit servicing[7]. The draft law does not appear to provide additional protection to borrowers, as the existing consumer protection framework applies regardless of whether the mortgage is held and serviced by the original lender, or is transferred to a purchaser and serviced through a credit

6 See paragraph 2.2.1 of Opinion CON/2018/13 and paragraph 3.1 of Opinion CON/2013/34.

7 Following the amendments made to Part V of the Central Bank Act 1997 by the Consumer Protection (Regulation of Credit Servicing Firms) Act 2018, the term 'credit servicing' in relation to a credit agreement is defined to include holding the legal title to credit granted under the credit agreement.

servicing firm[8].

3.3.3 The ECB notes that, for a number of reasons, addressing high levels of NPLs has been one of the ECB's supervisory priorities since the inception of the Single Supervisory Mechanism[9]. First, NPLs weigh on the balance sheets of credit institutions, curbing their profits. Second, NPLs are distracting for credit institutions, and represent a drain on their resources. Third, NPLs undermine investors' confidence in credit institutions. In addition, internal analysis by the ECB shows that, over recent years, credit institutions with high stocks of NPLs have consistently lent less than credit institutions whose loans are of better credit quality, thereby providing less support to firms and households and the economy generally[10]. Further, high stocks of NPLs are a macroprudential issue and often affect entire economies[11].

3.3.4 It is worth considering in further detail how the draft law may impact the ability to address high levels of NPLs, and why this may raise concerns from a supervisory perspective. First, it is noted that the other elements of the toolkit available to credit institutions to reduce NPLs include split mortgages, mortgage-to-rent schemes and voluntary surrender. However, these solutions rely on the engagement of the borrower. Currently, repossession activity in Ireland remains limited, and the length of proceedings continues to be protracted[12]. In such a context, some borrowers may not be incentivised to engage fully with these solutions, and the draft law may further adversely affect the balance of incentives from the point of view of borrowers. The protracted nature of some NPL workouts can have a significant impact on the balance sheets of the credit institutions involved, given the time value of money: the value of an asset must be discounted over time until its value can be realised. Using even modest interest rates, a delay of several years in the workout of an NPL can have a significant impact on valuation due to the compounding of interest. In those circumstances the effect of the draft law would be to deprive credit institutions of the possibility of disposing of non-performing portfolios that can be worked out by transferees which have specialised expertise and a specialised business model. Removing this possibility would have serious implications for credit institutions' balance sheets.

3.3.5 Second, the proper management of NPL exposures, in full compliance with both prudential requirements and the consumer protection framework, is an expensive process; it requires specialised expertise which consumes valuable resources that could otherwise be devoted to the prudent management of the credit institution. When NPL stocks on credit institutions' balance sheets reach critical levels the burden can become severe and debilitating. Credit institutions' ability to sell portfolios of assets can alleviate these issues, strengthen credit institutions' balance sheets, and reduce the costs of capital and funding. However, the draft law is likely to impede credit institutions' ability to sell portfolios of assets.

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8 See also paragraph 2.4.1 of Opinion CON/2018/31 and paragraph 2 of Opinion CON/2014/69.

9 See the speech by Danièle Nouy, Chair of the Supervisory Board of the ECB, and Sharon Donnery, Chair of the ECB's High Level Group on non-performing loans, 'Introductory remarks to the public hearing on the draft addendum to the ECB guidance to banks on non-performing loans', Frankfurt am Main, 30 November 2017, available on the ECB's Banking Supervision website at www.bankingsupervision.europa.eu.

10 See 'European banking supervision three years on,' Welcome remarks by Mario Draghi, President of the ECB, at the second ECB Forum on Banking Supervision, Frankfurt am Main, 7 November 2017, available on the ECB's website at www.ecb.europa.eu.

11 See paragraph 1 of Opinion CON/2018/32.

12 European Commission, Post-Programme Surveillance Report. Ireland, Spring 2018, 6 July 2018, page 17.

3.3.6 Third, the draft law may have an adverse impact on current and prospective Irish borrowers generally. When pricing mortgages and setting interest rates, credit institutions take account of many factors including: the actual and future cost of funding; expenses and overheads; the cost of capital; and expected credit losses. By depriving credit institutions of an important tool available for the workout of NPLs, additional costs would be generated. These additional costs are likely to be passed on to other borrowers and could result in a significant impact on mortgage pricing and availability – further increasing interest rates charged to borrowers in Ireland, including holders of variable rate mortgages – and potentially leading to higher levels of NPLs.

3.4 *Effects on secondary markets for credit institution assets*

3.4.1 The ECB has been a strong proponent of the development of secondary markets for credit institution assets – particularly NPLs – as reflected in the action plan of the Council of the European Union to tackle NPLs in Europe[13]. In the context of the large stocks of NPLs that remain on the balance sheets of some European credit institutions, and as part of a comprehensive solution to NPL resolution[14], the development of secondary markets may contribute to reducing NPLs. Looking ahead, well-functioning secondary markets may also prevent stocks of NPLs from building up in the future.

3.4.2 Moreover, a well-functioning secondary market for credit institution assets may have a positive effect on financial stability to the extent that it could facilitate the transfer of NPLs off credit institutions' balance sheets. As noted above, the presence of significant volumes of NPLs on credit institutions' balance sheets reduces the ability of those institutions to fulfil their function as providers of credit to the real economy, and hampers the operational flexibility and overall profitability that are essential to a well-functioning banking sector. It is essential that the national legal framework applicable to secondary markets enables the efficient transfer of NPLs off the balance sheets of credit institutions.

3.4.3 From a procedural perspective, further consideration should be given to the practical implications of the draft law on the process for transferring portfolios of mortgages, whether performing or non-performing. The provisions of the draft law would mean that a credit institution could only approach borrowers to obtain their consent after the completion of negotiations between the transferee and the credit institution, and the conduct and completion of due diligence in respect of the portfolio. Thus, consent could only be sought once various terms of the transfer, including the price, have been agreed. If one or more borrowers in the portfolio refuse to grant consent, the agreed terms would have to be renegotiated. This is likely to render such transfers effectively impossible and, in any case, increase costs and impede the functioning of secondary markets for credit institution assets.

3.4.4 In this context, the draft law must carefully balance the benefits of creating well-functioning

13 See the Council of the European Union's press release of 11 July 2017 on the 'Council conclusions on Action plan to tackle non-performing loans in Europe', available at: http://www.consilium.europa.eu/en/press/press-releases/2017/07/11/conclusions-non-performing-loans/. See also Opinion CON/2018/31.

14 See, for example, Special features, Section B of the ECB's November 2016 Financial Stability Review, available at: https://www.ecb.europa.eu/pub/pdf/other/sfbfinancialstabilityreview201611.en.pdf.

secondary markets against the need to protect borrowers. The draft law would impede the transfer of NPLs off credit institutions' balance sheets and impede the development of secondary markets. As noted above, if credit institutions (or secondary market purchasers of assets) are deprived of efficient tools to work out NPLs in an effective and timely manner, the result could be unnecessarily high levels of NPLs and private sector debt, which in turn have an adverse impact on financial stability and could undermine future credit supply[15].

3.5 *Effects on financial stability*

The implementation of the draft law would entail financial costs for the banking sector. Given the scope of the draft law and the importance of mortgage portfolios in total credit institution assets, these factors would have a negative impact on the profitability, capitalisation and future lending capacity of the credit institutions affected, and ultimately may have implications for financial stability. Combined with the potential impact of a shift away from stable, relatively cheap, central bank funding towards more volatile wholesale markets, the draft law could undermine financial stability.

3.6 *Effects on the Irish economy*

In view of the above considerations, the draft law is likely to adversely affect the future supply of credit and the pricing of mortgages. Credit institutions may respond to the likely increases in finance costs resulting from the draft law by unduly tightening lending conditions, in particular by charging higher interest rates and by decreasing lending volumes – with a potentially negative compositional effect in terms of credit allocation. This could reduce economic capacity in Ireland.

3.7 *Impact on tasks of Central Bank of Ireland*

The draft law does not confer genuinely new tasks on the CBI in the area of prudential supervision or consumer protection. Rather, it complements the CBI's existing tasks, in particular in the field of supervision of regulated financial service providers and regulated businesses. For example, in respect of retail credit firms and credit servicing firms, the CBI already has powers to authorise and supervise such entities, to make them subject to CBI codes or directions, and to take enforcement measures against them – including for the purposes of protecting natural persons and micro, small or medium-sized enterprises that have entered into credit agreements[16]. Consequently, the question of whether new tasks conferred on a national central bank constitute government tasks in the context of the prohibition of monetary financing does not arise[17].

3.8 *Compliance with Irish constitutional and other legal principles*

It is for the Irish authorities to assess whether the draft law, including its potentially retroactive

15 See paragraphs 2.2 and 2.3 of Opinion CON/2015/14.

16 See sections 28 to 36N of the Central Bank Act 1997, as amended. See also the recent Consumer Protection (Regulation of Credit Servicing Firms) Act 2018.

17 See paragraph 3.1 of Opinion CON/2018/27.

character, complies with Irish constitutional and other legal principles, in particular property rights. For its part, the ECB notes that introducing measures with retroactive effect would undermine legal certainty and not be in line with the principle of legitimate expectations.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 29 March 2019.

[signed]

The President of the ECB

Mario DRAGHI