E&S risk management guidance for non-performing loan asset management institutions

European Bank
for Reconstruction and Development

Introduction

The EBRD partners with financial intermediaries (FIs) including private equity funds, banks, leasing companies, insurance companies and pension funds, as well as non-performing loan (NPL) asset management companies and servicers ("the servicers") engaged in a wide range of financial activities.

The EBRD is one of the main founders of the Vienna Initiative, a framework for safeguarding the financial stability of emerging Europe. The Vienna Initiative launched a dedicated workstream with the overall objective of establishing institutions and processes for the resolution of NPLs and the parallel process of financial restructuring in enterprises. High NPL levels have been a major challenge for the financial sectors of several economies in which the EBRD operates. NPLs depress credit activity, growth and ultimately job creation, perpetuating the private-sector debt problem.

In early 2020, the EBRD commissioned a case study identifying social issues in NPL portfolios in the Greek market, where the EBRD has its highest exposure to NPL transactions and is looking to invest further. The study showed that the poorly managed recovery of NPLs can have considerable social impact on small and medium-sized enterprises (SMEs), households, individuals and, thus, communities in general. These impacts are related to the nature of the recovery process and the economic circumstances of affected SMEs and families (households).

Social risks in NPL transactions

Social risks are the existing or potential negative consequences to a debtor trying to repay a non-performing loan, either a corporate entity (SMEs) or a household (individuals, families). Failure to effectively manage social risks related to NPL portfolios may lead to financial, legal and reputational consequences for a servicer[1]. Indicative social risks, to which debtors in NPL portfolios may be exposed, may include:

- Economic consequences
  a. problems in making ends meet
  b. unemployment or loss of income
  c. payment delays
  d. decrease in professional performance
  e. search for additional employment
  f. loss of property (foreclosure) or assets
- Social consequences
  g. children moving back in with parents
  h. eviction (forced or not)
  i. emigration/relocation
  j. termination of children's studies
  k. homelessness
  l. termination of habits (leisure time activities)
  m. arguments/tensions in family and work
  n. social exclusion
  o. divorce
  p. delinquent behaviour
- Impact on health and well-being of individuals
  q. insufficient care for children, elderly, other vulnerable categories
  r. loss of property (foreclosure) or assets
  s. psychological/mental health disorders
  t. physical health disorders
  u. alcoholism
  v. suicide
  w. abuse

Therefore, social risk management and mitigation constitute an integral part of the servicer's governance structure, policies and procedures. They should be incorporated into the servicer's overall risk management framework and environmental and social management system (ESMS), where relevant, in accordance with the EU substantive standards (the Directive on credit servicers and credit purchasers[2]).

The servicer's staff (or the staff of relevant third parties when debt collection is outsourced) should be adequately trained, including training on social issues, at least yearly.

Servicers are expected to hire officers with expertise in the management of social risks. They are also expected to assign a budget for any due diligence and mitigation measures needed for the management of social matters, as well as proper training by qualified internal staff or external experts.

1 A non-performing-loan servicer is a specialised financial services entity that engages in certain stages of the non-performing-loan lifecycle. The primary objective of the servicer is to collect payments and manage the non-performing credit assets on behalf of the entity that originated (or last held) these assets.

2 See EU(2021).

Governance of NPL servicers

All FIs, including NPL servicers, need to comply with EBRD Environmental and Social (E&S) Performance Requirements (PRs):[3]

- PR2 (labour and working conditions)
- PR4 (occupational health and safety)
- PR9 (financial intermediaries).

A servicer is expected to designate a **senior executive** with accountability to oversee all social risk and impact procedures and processes. This executive has primary responsibility for the adoption and enforcement of these processes within the FI.

Another executive – usually a **risk officer** or a staff member accountable for day-to-day risk management – should have primary responsibility for managing the social risk and impacts of NPL transactions.

The servicer should also provide management resources (financial, human and technological) for:

- the internal provision of social performance data to management
- reviewing the social risk and impact procedures and processes on a regular basis
- delivering adequate reporting to stakeholders (including the EBRD) based on yearly performance data.

The risk officer must ensure that the servicer implements social risk procedures (including appropriate social due diligence). They must also ensure that regular social risk and impact training is provided to executives and credit officers, so that the servicer's staff can identify, assess and manage the social risks of NPL transactions and customers (both corporate and individual borrowers). Furthermore, the risk officer will be involved in managing complaints related to social matters.

The servicer's **board**, along with the **risk committee** (or other competent function), needs to follow up on social risk performance periodically, at least once every two years, discussing strengths and weaknesses, as well as areas of improvement.

Specific ESMS requirements

Servicers have the responsibility to assess, identify, manage and monitor social risks associated with the NPL portfolio, making sure that each is managed in a socially responsible way. As part as the ESMS required under PR9, servicers need to establish:

- a robust code of conduct in line with applicable and relevant national requirements
- policies and procedures for the assessment of the social risk status of the borrower and vulnerable customers

When it comes to the asset management and servicing of NPL portfolios, a good ESMS will include:

- screening loans in an NPL portfolio against the EBRD E&S exclusion list[4]
- categorising NPL loans in each asset class (for example, mortgage/residential/property loans, consumer loans, student loans, credit cards, corporate loans and SME loans) and identifying major social issues (on a best-effort basis)
- categorising loans as secured or unsecured (that is, if collateral is in place) and at what percentage (in terms of €/US$ value) of the NPL portfolio
- special flags (continuously identified) for mortgages that serve as collateral and are the primary residence of the borrower, and possibly against auctions/evictions by applicable law
- reporting incidents of social issues related to the NPL portfolio and each asset class, and vulnerable-customer flags and actions
- establishing a robust grievance mechanism, including a grievance resolution policy and points of contact for all stakeholders
- a reporting system that covers complaints, resolutions, actions taken according to the applicable code of conduct and relevant policies and procedures
- reporting on the number of actions (calls, SMS, emails, and so on) that did not include straightforward reference to the code of conduct adhered to by the servicer, and the reasons for such exclusions
- reporting recovery rates (on an aggregate level and per asset class, secured versus unsecured, on an annual basis).

Market evidence suggests possible linkages between the **eviction of borrowers** from their primary residence as a result of default on a mortgage loan. Servicers need to keep track of any evictions (forced or not) due to NPLs in their portfolios.

Servicers should develop a tracking and reporting mechanism for issues such as:

- how many evictions have taken place as a result of an NPL from a current portfolio during a specific period of time
- how many of these evictions were forced
- how many of the evicted people have been safely relocated to another decent and safe residence
- how many of the evicted people have been left homeless
- how many of the evicted people have received and will continue to receive federal/state/municipal social care (if any) and for what period of time
- a breakdown of evicted people (in absolute numbers and percentages) as follows:
  - men
  - women
  - children (aged under 18)
  - elderly
  - vulnerable groups.

3 More information on PR2, PR4 and PR9 and relevant guidance notes can be found at: https://www.ebrd.com/who-we-are/our-values/environmental-and-social-policy/implementation.html

4 In addition to the EBRD E&S exclusion list, the following activities are typically excluded from financing using EBRD funds: the production of arms or military equipment; the production or export of tobacco products or hard liquor; and casinos and other gambling facilities.

As, most of the time, it is auctions that lead to evictions, servicers should also keep record of NPLs that result in house auctions (primary residence).

Servicers should further develop a tracking and reporting mechanism for issues such as:

- how many auctions of primary residences have taken place as a result of an NPL from a portfolio during a specific period of time
- how many of these auctions took place via:
  - an official electronic auction portal, regulated by a national competent authority, or
  - physically (live, in-person)
- how many of these auctions resulted in evictions
- the number of auction cases in which the borrowers were able to repossess their property.

If servicers outsource debt recovery to third parties (that is, collection agencies and/or law firms), they should maintain:

- a list of third parties with which they collaborate, including details of licenses and authorisations as required by local laws and regulations, and a list of international, national and internal codes of conduct to which each third party adheres.

The EBRD may request a set of social covenants to be included in NPL transaction agreements. In this context, servicers are expected to draft a set of social covenants for contracts and service agreements with debt-collection agencies and law firms when they outsource debt collection. Examples of social covenants may include:

- trained and qualified employees of third parties (sub-contractors)
- specific social management procedures as part of the ESMS
- accountable and trained staff responsible and implementing the ESMS.

When subcontracting (outsourcing debt collection), servicers should develop and implement a sub-contractor management plan and should:

- include equivalent requirements in contractual agreements with their subcontractors
- require contracting parties to provide regular (at least annual) training to their staff on social issues associated with and the implications of NPLs.

Servicers and their subcontractors (that is, collection agencies and/or law firms) must ensure the **safety and security of their staff.** When servicers outsource debt recovery to third parties servicers must ensure that these parties are not hiring staff that use force or intimidation when dealing with borrowers. They should explicitly forbid the use of intimidation or force against people or property, with a provision in their code of conduct and/or contractual agreements with such parties, and provide regular training.

Stakeholder engagement and grievance mechanism

The servicer should put in place a comprehensive system for effective communication and reporting for internal and external stakeholder groups. It should provide channels of communication and reporting to deal with internal and external communication on social matters, involving enquiries, grievances or comments from all stakeholders. Under PR9, servicers must establish a grievance mechanism to receive and facilitate the resolution of stakeholder grievances. The grievance mechanism should be scaled to the risks and potential adverse impacts of the NPL transactions and the issues involved, including social issues.

As a transparency best practice and to build trust with stakeholders, servicers should communicate on a publicly available domain, primarily their website, at a minimum the following information:

- a brief outline of their business model and operational practices
- any internal corporate code of conduct (either at a local or group level)
- the legal frameworks they need to comply with and in which countries (or regions) of operation
- regulators, supervisors and/or other competent authorities that monitor, safeguard and regulate their operations
- a comprehensive grievance mechanism for lodging complaints.

Servicers should also maintain proper records of risks identified and managed for each transaction, including social risks, for each client. Records, documents and reports on social issues should be available for inspection by investors and stakeholders with legal interest (including EBRD executives) free of charge.

Reporting to the EBRD

All FIs, including partnering servicers, are required to report to the EBRD on yearly basis on their implementation of the applicable PRs and their management of the E&S risks in their portfolios through the Annual Environmental and Social Report (AESR). If the EBRD holds an equity stake in the servicer, they are required to report on all NPL transactions in their portfolio.

References

EU (2021), *Directive (EU) 2021/2167 of the European Parliament and of the Council of 24 November 2021 on credit servicers and credit purchasers and amending Directives 2008/48/EC and 2014/17/EU*, Brussels. Available at https://eur-lex.europa.eu/eli/dir/2021/2167/oj.

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