Client Alert

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Luxembourg: Implementation of the non-performing loan directive and welcome clarification of the Luxembourg law on financial collateral arrangements

In brief

On 22 July 2024, the Luxembourg law ("**Law**") transposing Directive (EU) 2021/2167 of the European Parliament and of the Council of 24 November 2021 on credit servicers and credit purchasers ("**NPL Directive**") and operationalizing Regulation (EU) 2022/2036 concerning the prudential treatment of globally systemically important institutions into Luxembourg law entered into force.

The NPL Directive enables credit institutions to sell their non-performing loans (NPLs) on secondary markets to specialized operators, in order to reduce excessive outstanding NPLs on their balance sheet and to prevent their possible future accumulation. The NPL Directive's ultimate goal is to preserve financial stability and encourage lending activity.

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The purpose of the Law is thus to facilitate and regulate the transfer of a creditor's rights or assignment of NPLs to credit purchasers. The credit purchasers have to respect certain obligations, including in particular the obligation to appoint a credit servicer, a new category of financial sector professional under the Luxembourg law dated 5 April 1993 on the financial sector (LFS), as amended, subject to an authorization procedure and prudential supervision by the *Commission de Surveillance du Secteur Financier* (CSSF), in order to manage credit contracts concluded with consumers.

The Law also makes targeted modifications to the existing provisions of the Consumer Code, allowing a strengthening of the legal framework through the transposition of the NPL Directive. These targeted modifications relate, among other things, to consumer credit contracts as well as real estate credit contracts.

The Law further operationalizes the specific modifications that Regulation (EU) 2022/2036 makes to Directive 2014/59/EU (BRRD), which deals with the framework for the recovery and resolution of credit institutions and investment firms, in the amended Luxembourg law of 18 December 2015 relating to the failure of credit institutions and certain investment firms.

Finally, the Law amends the amended Luxembourg law of 5 August 2005 on financial collateral arrangements ("**2005 Law**") with a view to clarifying the legislator's initial intention regarding the legislative framework for securing Luxembourg financial collaterals, and in particular setting aside any national or foreign insolvency, competition and seizure rules likely to affect their normal operation.

For further information and to discuss what this development might mean for you, please get in touch with your usual Baker McKenzie contact.

Key takeaways of the new rules on NPLs

1. **Transfer or assignment of NPLs initially granted by an EU credit institution**

   The NPL Directive establishes a framework to enable credit institutions, when they are confronted with a large accumulation of NPLs and do not have the necessary personnel or expertise to manage them properly, to either outsource the management of

these loans to a specialized credit servicer or assign the credit agreement to a credit purchaser with the risk appetite and expertise necessary to manage it.

a. **What is an NPL transaction under the Law?**

NPLs are bank loans that are subject to late repayment (more than 90 days past due) or are unlikely to be repaid by the borrower (without recourse by the credit institution to actions such as realizing security).

An NPL transaction refers to the transfer of creditor's rights or the non-performing credit agreement itself from a bank's balance sheet to a credit purchaser. This process involves providing the credit purchaser with the necessary information to assess the value and recovery prospects of the NPL while ensuring confidentiality. The transaction facilitates the creation of a secondary market for NPLs, enabling banks to offload these troubled assets and potentially improve their balance sheets.

The Law applies to NPLs initially granted by an EU credit institution that are transferred to a credit purchaser that is not a credit institution.

b. **What are the rights and obligations of credit institutions?**

A credit institution must provide a prospective credit purchaser with essential information about the creditor's rights under an NPL or the NPL itself, and if applicable, the collateral.

Luxembourg credit institutions must submit on a bi-annual basis a report to the CSSF about the transfers to credit purchasers of creditor's rights under a non-performing credit agreement, or the non-performing credit agreement itself, including the legal entity identifier for the credit purchaser or its representative, the creditor's rights outstanding, the volume of the rights transferred and other relevant information.

Such communication to the CSSF is made on a quarterly basis in particular in periods of crisis where the number of transfers may significantly increase.

c. **What are the rights and obligations of credit purchasers?**

As per the Law, credit purchasers are defined as any natural or legal person, other than a credit institution, who, in the course of its commercial or professional activities, purchases the rights held by a creditor under a non-performing credit agreement or the non-performing credit agreement itself.

Upon receiving the necessary information about the creditor's rights under an NPL or the NPL itself, the credit purchaser is required to keep the information and business data confidential. The framework governing banking secrecy has been adapted to ensure that credit purchasers have the necessary information to assess the risk it represents.

If the credit purchaser lacks the required authorization, they must designate either a credit institution based in the EU, a non-credit institution overseen by a competent authority of a Member State, or a credit servicer to perform activities related to the creditor's rights under an NPL or the NPL itself, particularly when the NPL is concluded with consumers.

If a credit purchaser does not have a domicile in a Member State or does not have a registered office or headquarters within a Member State, they must appoint a representative who resides in a Member State or has a registered office or headquarters within a Member State.

In the agreement with the credit servicer, the credit purchaser must include some specific information and documents listed in the Law.

Lastly, both the credit purchaser and the credit servicer are obligated to act in good faith, fairly and professionally. They must provide accurate and clear information that is not misleading or false. They must respect and protect the personal information and privacy of the borrowers. They must communicate with borrowers in a manner that does not involve harassment, coercion, or undue influence. Before the first debt collection and whenever requested by the borrower, the credit purchaser (or the credit servicer, if any) should provide the borrower with specific information as per the Law.

d. **What is a credit servicer? What are its role and obligations?**

In line with the NPL Directive, the Law regulates the activity of credit servicers. In that respect, a new category of professional of the financial sector is created in the LFS: the credit servicer.

The credit servicer is described as a legal person that, in the course of its business, manages and enforces the rights and obligations related to a creditor's rights under a non-performing credit agreement, or to the non-performing credit agreement itself, on behalf of a credit purchaser, and carries out at least one or more credit servicing activities.

These activities may encompass the following:

- Collecting and recovering due payments from borrowers that are associated with a creditor's rights under a non-performing credit agreement or the non-performing credit agreement itself.
- Renegotiating terms and conditions with borrowers that are related to a creditor's rights under a credit agreement, or the credit agreement itself, following the instructions provided by the credit purchaser — this is applicable when the credit servicer is not acting as a credit intermediary.
- Handling any complaints that pertain to a creditor's rights under a credit agreement or the credit agreement itself.
- Notifying borrowers about any modifications in interest rates or charges, or any due payments that are associated with a creditor's rights under a credit agreement or the credit agreement itself.

Luxembourg-based credit servicers must be authorized by the CSSF and will be under its prudential supervision.

The CSSF's authorization may only be granted to legal entities. The authorization does not entitle the credit servicer to carry on the activity under the cover of another person or as an intermediary.

It is subject to proof of subscribed and paid-up share capital of at least EUR 75,000, where the applicant is not authorized to receive and hold funds from borrowers for the purpose of transferring them to credit purchasers and of EUR 150,000, where the applicant is authorized to receive and hold funds from borrowers in order to transfer them to credit purchasers.

Where a credit servicer does not intend to receive and hold funds from borrowers as part of its business model, a statement confirming its intention must be included in its application for authorization.

Otherwise, when receiving and holding borrowers' funds:

- The applicant is obliged to hold a separate account with a credit institution, into which all funds received from borrowers must be paid and kept until they are passed on to the credit purchaser concerned.
- Funds received from borrowers in that context are protected against recourse by other creditors of the credit servicer in the event of the credit servicer's insolvency, and do not form part of the estate.
- Any payment is deemed to have been made to the credit purchaser when a borrower makes a payment to a credit servicer in order to reimburse all or part of the amounts due in connection with the creditor's rights under a non-performing credit agreement, or the non-performing credit itself.
- The credit servicer gives the borrower a receipt or letter of discharge acknowledging the amounts received, on paper or on another durable medium, each time the credit servicer receives funds from the borrower.
- The credit servicer must account for funds received from borrowers separately from its own assets, which does not constitute the servicing of third-party funds for the purposes of the LFS.
- An approved credit servicer may continue to carry out credit servicing activities in respect of non-performing credits that become performing again during the course of credit servicing.

A credit institution could also have recourse to a credit servicer for the management of its NPLs.

The Law explicitly excludes from its scope the credit servicing activities provided by the following entities for which no licensing is therefore required under the Law:

- A credit institution established in Luxembourg.
- An alternative investment fund manager authorized or registered in accordance with the amended law of 12 July 2013 relating to alternative investment fund managers.
- A management company or an investment company authorized in accordance with the amended law of 17 December 2010 concerning undertakings for collective investment (provided that the investment company has not appointed a management company under the said law, on behalf of the fund it manages).
- A lender other than a credit institution within the meaning of Article L. 226-1, point 20, of the Consumer Code subject to the control of a competent authority in accordance with Article L.226-4 of the said Code, or a lender within the meaning of Article L. 224-2, letter a) of the Consumer Code, which is not a credit institution subject to the control of a competent authority in accordance with Article L.224 -21 of said Code.

To foster the development in the European Union of secondary markets for NPLs and to establish a framework for managers of non-performing credit agreements entered into by credit institutions and purchased by credit purchasers, the NPL Directive further puts in place an authorization procedure for credit servicers and a framework for carrying out credit servicing activities in a cross-border context.

The new Articles 28-18 and 28-20 introduced into the LFS by Article 30 of the Law establish a specific regime (passport) for the exercise of cross-border activities by credit servicers.

e. **What is a credit servicing agreement?**

When a credit purchaser does not perform credit servicing activities itself, the designated credit servicer provides its services relating to the management and enforcement of the creditor's rights under a non-performing credit agreement, or the non-performing credit agreement itself, on the basis of a credit servicing agreement concluded with the credit purchaser.

The credit servicing agreement shall contain the following:

1° A detailed description of the credit servicing activities to be carried out by the credit servicer.

2° The level of remuneration of the credit servicer or the method of calculating his remuneration.

3° The extent to which the credit servicer may represent the credit purchaser vis-à-vis the borrower.

4° A commitment by the parties to comply with EU and national law applicable to the creditor's rights under a credit agreement or to the credit agreement itself, including in terms of consumer protection and data protection; and

5° A clause requiring the fair and diligent treatment of borrowers.

The credit servicing agreement contains a requirement that the credit servicer informs the credit purchaser before outsourcing any of its credit servicing activities.

The credit servicer shall keep and preserve the following records for a period of five years from the date of termination of the credit servicer agreement, but in any event for a maximum period of 10 years:

1° Relevant correspondence with the credit purchaser and borrower.

2° Relevant instructions received from the credit purchaser concerning the creditor's rights under each non-performing credit agreement, or the non-performing credit agreement itself, which it manages and executes on behalf of the credit purchaser.

3° The credit servicing agreement.

Credit servicers shall make these records available to the CSSF on request.

Where a credit servicer provides a credit purchaser with services relating to the servicing and enforcement of the creditor's rights under a non-performing credit agreement, or under the non-performing credit agreement itself, on the basis of an agreement between the credit servicer and the credit purchaser, the credit servicer may transfer the necessary information to the credit purchaser.

f. **What is the credit servicing provider?**

Credit servicers may outsource the provision of any credit servicing activities to a credit servicing provider.

Where a credit servicer uses a credit servicing provider to carry out any credit servicing activity, it remains fully responsible for compliance with all the obligations.

Outsourcing these credit servicing activities is subject to the following conditions:

1° A written outsourcing agreement is concluded between the credit servicer and the credit servicing provider under which the latter is obliged to comply with the provisions of the Law and the provisions applicable to the creditor's rights under a credit agreement or to the credit agreement itself.

2° The simultaneous outsourcing to a credit servicing provider of all credit servicing activities is prohibited.

3° The contractual relationship between the credit servicer and the credit purchaser, and the credit servicer's obligations toward the credit purchaser or borrowers are not modified by the outsourcing agreement concluded with the credit servicing provider.

4° The credit servicer's compliance with its licensing requirements is not affected by the outsourcing of part of its credit servicing activities.

5° Outsourcing to a credit servicing provider is not an obstacle to supervision by the CSSF of a credit servicer, including in the context of the provision of cross-border services.

6° The credit servicer has direct access to all relevant information concerning the services outsourced to the credit servicing provider.

7° In the event of termination of the outsourcing agreement, the credit servicer continues to have at his disposal the expertise and resources necessary to carry out the outsourced credit servicing activities.

Credit servicing activities should not be outsourced in any way that compromises the quality of the credit servicer's internal controls, or the soundness or continuity of its credit servicing activities.

The credit servicing provider to which credit servicing activities have been outsourced complies with the provisions of the Law on an ongoing basis.

The credit servicer shall inform the CSSF and, where appropriate, the competent authorities of the host Member State before outsourcing its credit servicing activities.

The credit receiver keeps and retains records of the relevant instructions issued to the credit servicing provider, together with the outsourcing agreement, for five years from the date of termination of the agreement, but in any event for no longer than 10 years.

The credit servicer and the credit servicing provider shall make such information available to the CSSF on request.

Credit servicing providers are not authorized to receive and hold funds from borrowers.

Where a credit servicer uses a credit servicing provider to carry out credit servicing activities under the Law, the credit servicer may transfer the necessary information to the credit servicing provider.

g. **What are the CSSF's role and powers?**

The CSSF will oversee and evaluate ongoing compliance of credit servicers with the Law, including credit servicers authorized in Luxembourg who conduct credit servicing activities in other EU Member States. As the supervisory authority, the CSSF has the authority to investigate and apply administrative sanctions and measures in accordance with the Law.

For example, in case of non compliance with the Law, the CSSF may withdraw a credit servicer's authorization, pronounce an injunction to remedy the violation, issue a temporary or permanent ban from exercising credit servicing activities, or apply administrative fines up to EUR 5 million or 10% of the total annual turnover for legal persons and up to EUR 5 million for natural persons.

2. **Amendments relating to consumer credit agreements and mortgage credit agreements**

The NPL Directive also brings changes to existing directives on consumer credit agreements (Directive 2008/48/EC) and mortgage credit agreements (Directive 2014/17/EU). These amendments introduced by the Law in the Luxembourg Consumer Code aim to:

- Strengthen the legal framework by improving information communication to consumers in case of contract modifications.
- Introduce new provisions for late payment and performance whereby lenders must have adequate policies and procedures in place to encourage them, where appropriate, to exercise reasonable forbearance before initiating enforcement proceedings. These renegotiation measures must take into account the specific circumstances of the consumer and may include an extension of the duration of the credit agreement, the postponement of payment of all or part of the repayment instalments for a given period, the modification of the interest rate or the partial debt forgiveness and debt consolidation.
- Introduce new provisions whereby, when the creditor's rights under a credit agreement or the credit agreement itself are assigned to a third party, the consumer may assert against the assignee any defense that they could have asserted against the original creditor, including the right to set-off insofar as this is legally permitted. The consumer will be informed of that assignment, except where the original lender, in agreement with the assignee, continues to grant the consumer a right of set-off.

Operationalization of Regulation (EU) 2022/2036: prudential treatment of global systemically important institutions

The Law further operationalizes Regulation (EU) 2022/2036 of the European Parliament and of the Council of 19 October 2022 amending Regulation (EU) No 575/2013 and Directive 2014/59/EU as regards the prudential treatment of globally systemically important institutions according to a multiple entry point resolution strategy and methods for the indirect underwriting of instruments eligible for the minimum requirement to own funds and eligible liabilities.

These amendments aim to strengthen the regulatory framework applicable to bank resolution, by reviewing the treatment of banking groups whose resolution strategy has multiple entry points, as opposed to a single entry point strategy, in order to better align this treatment with that provided for by international standards, and better take into account third-country entities within them.

Amendment to the Luxembourg law on financial collateral arrangements

Finally, the Law amends the 2005 Law to significantly bolster the protection of financial collateral arrangements and compensation agreements entered into after 22 July 2024. This protection extends to circumstances involving winding-up proceedings, reorganization measures and other competitive situations, irrespective of their origin or jurisdiction. This change addresses and resolves the uncertainty raised by recent case law, which suggested that financial collateral arrangements might not be safeguarded under the 2005 Law if the related proceedings were initiated outside the European Economic Area (EEA). By amending the 2005 Law, the legislator has clarified that the protections afforded by this law apply universally, regardless of where the proceedings are initiated. This ensures that financial collateral arrangements remain insulated from the risks associated with insolvency procedures and reorganization measures in any jurisdiction. The amendment reinstates confidence in the enforceability of these arrangements, confirming greater security for parties involved in financial transactions that rely on Luxembourg's legal framework for collateral. Additionally, the amendment introduces precise definitions for "foreign law" and "foreign reorganization and liquidation measures," which cover provisions, laws and measures from both EEA member states and any other country. This expansion guarantees that the protections under Articles 20 and 24 of the 2005 Law continue to be upheld against third parties, ensuring that Luxembourg's financial collateral arrangements maintain their validity and enforceability worldwide.

Contact Us

Laurent Fessmann
Partner
Laurent.Fessmann@bakermckenzie.com

Jean-François Trapp
Partner
Jean-Francois.Trapp@bakermckenzie.com

Ana Vazquez
Counsel
Ana.Vazquez@bakermckenzie.com

Alexis Bouvet
Counsel
Alexis.Bouvet@bakermckenzie.com