



# NPL Resolution Strategy



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## Sale of banks' retail NPLs and personal (consumer) insolvency

This paper examines the problems posed by non-performing debt owed by retail clients to banks and debt buyers ('distressed personal debt' or 'retail NPLs') in Serbia and proposes a range of likely options for their resolution.

### 1. Background

The Serbian Government's [NPL Resolution Strategy](#) (*Official Gazette of the Republic of Serbia* No. 72/15, 'the Strategy') and its accompanying programmes and action plans largely focus on commercial NPLs. These instruments envisage broad-based changes to the regulatory framework and other tools used for decades in developed financial markets.


Currently, NPLs account for 3.9 percent of all outstanding loans (source: [Trends in Lending, Fourth Quarter Report 2019](#), National Bank of Serbia, March 2020), a proportion that does not pose a particular concern.

However, in late April 2015, NPLs totalled 442.6 bn dinars (3.7 bn euros), with the gross ratio of NPLs to all outstanding loans reaching 23 percent (source: Strategy). This amount does not include NPLs held by insolvent banks, which amount to over 2 bn euros.

Much of this distressed debt is secured by personal guarantees of private individuals, which means that hundreds of thousands of Serbians are neither unable to service their personal debt nor have access to instruments that would allow them to resolve this issue efficiently and effectively.

Moreover, this retail debt means the individuals concerned are highly incentivised to engage in informal ('shadow') employment, or to work for the minimum wage on paper and receive the remainder of their salaries cash-in-hand, as any earnings are liable to be attached by creditors. The practice affects these individuals' social and health insurance coverage, as well as reducing revenues collected by the state.

Insofar as it concerns retail NPLs, the Strategy mainly focuses on the avoidance of risky lending whilst devoting minimum attention to existing distressed personal debt. There is no indication this approach will alter any time soon, even though the Strategy does deal with these categories of debts as well.





## 2. Possible solutions and their objectives and impact

This report will take a general look at three possible solutions to this issue, some of which were envisaged in the Strategy as early as 2015 as potential avenues for addressing the problem to some extent. The options that will be discussed are:

1. Sale of banks retail NPLs;
2. Introduction of supervision arrangements for debt buyers and NPL servicers to ensure customer protection; and
3. Introduction of personal (consumer) insolvency and insolvency administrators for private individuals.

Moreover, Serbia is expected to adopt and apply these solutions as part of its progress towards European Union (EU) accession.

The expected impact can be viewed from the perspectives of four key stakeholders:

### 2.1 Individual borrowers

Private borrowers stand to gain the most from the sale of their debts with banks.

These claims would be sold in the secondary market at a discount, which means that their buyers would always, in each particular case, be ready to write off a part of an individual's debt.

Banks are unable to write off substantial portions of retail debt due in part to the well-known issue of moral hazard, as well as on account of tax implications. However, a more important reason is that forgiving debt would jeopardise the collection of its outstanding loans: borrowers would be motivated to wait for these loans to become non-performing, whereupon they could negotiate repayment at a discount, rather than continuing to service them. Ultimately, if banks behaved like debt buyers, lending would decline dramatically, which would shrink investment and reduce consumption and GDP.

Apart from being able to dispose of their debts at a partial discount, borrowers would also stand to benefit from:

- i. incentives to move away from undeclared work (which would concomitantly address the issue of health and social insurance);
- ii. no longer having to feign earning the minimum wage;
- iii. being able to borrow again;
- iv. being able to launch new business ventures; and
- v. greater legal certainty inherent in banks selling debt in the secondary market.



## 2.2 Banks holding distressed debt

Allowing banks to sell their retail debt would help them streamline their internal structures and cut costs, as they currently devote significant funds to managing hundreds of thousands of retail NPLs (including for back office expenses, collection costs, legal and valuers' fees, and the like) that have relatively low collection rates.

The positive effects for banks of being able to sell retail NPLs include:

- i. decrease in overall retail NPL rates;
- ii. greater revenue from sales of retail NPLs that could be used to finance new loans;
- iii. a broadened client base, as borrowers whose debt is sold in the secondary market could be removed from the delinquent debt register maintained by the Serbian Banks' Association Credit Bureau, which would allow them to borrow again; and
- iv. Cost and tax optimisation



## 2.3. Debt buyers and NPL servicers

Debt buyers (investment funds whose business relies on purchasing delinquent debt) and NPL servicers (collection agencies) would gain an opportunity to increase investment and expand into a major new segment of the market.

## 2.4 The financial market and the broader economy

Finally, in addition to meeting the interests of individual stakeholders, the proposed solutions would carry a number of benefits for society as a whole, including:

- i. incentivising formal employment for many people currently in undeclared work;
- ii. incentivising retail lending and consumption by allowing many individuals who are currently non-bankable due to poor credit history to access bank finance again;
- iii. releasing loan loss provisions and allowing banks to use these funds for lending;
- iv. permitting banks to funnel the proceeds of selling NPLs into new loans to businesses and households; and
- v. fostering development of the NPL market and attracting foreign investment in this segment, as far fewer foreign debt buyers operate in Serbia than in most advanced regional economies.

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### **3. Brief discussion of proposed solutions**

#### **3.1 Sale of banks' retail NPLs**

Article 39 of the [Financial Services Consumer Protection Law](#) (*Official Gazette of the Republic of Serbia* Nos. 36/2011 and 139/2014) practically bans the sale of retail NPLs by requiring both parties to such transactions (defined as 'assignment of the bank's claim under a credit agreement') to be banks. However, banks are not interested in investing in other banks' NPLs as this is not their core business and they are unable to engage in these activities as efficiently as professional investors. In addition, any purchased NPLs would increase the sum of distressed assets held on the balance sheets of banks and their parent groups, which may send the wrong signal to investors that these banks rely on for finance. This statutory provision is therefore almost never used in practice.

The proposed solution would entail amending the relevant article of the Financial Services Consumer Protection Law to permit banks to sell ('assign') retail NPLs not just to other banks, but to specialised professional investors as well.

This amendment would not constitute a major innovation in the Serbian legal system: selling debt used to be entirely permitted in Serbia until just a few years ago and is quite commonplace across the region and the EU.

#### **3.2 Introduction of supervision arrangements for debt buyers and NPL servicers to ensure customer protection of oversight of debt buyers and NPL servicers**

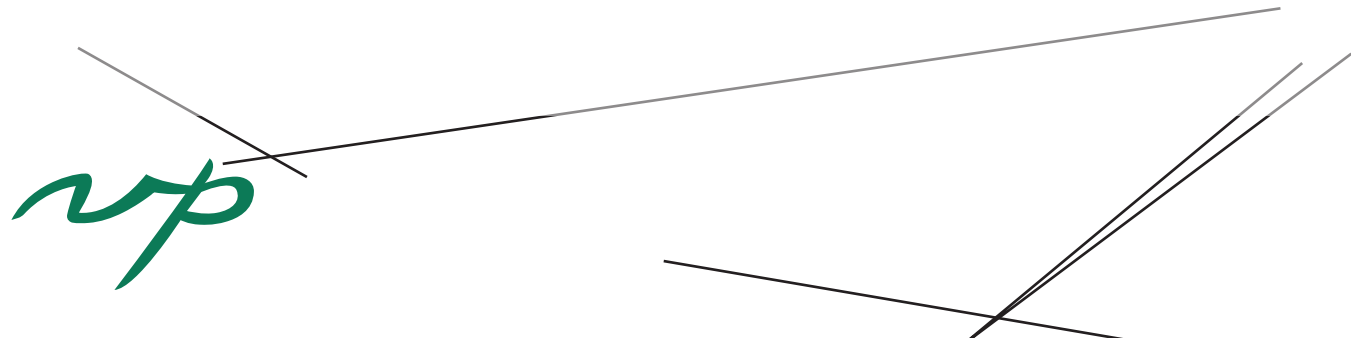
The Financial Services Consumer Protection Law gives customers a number of rights they can exercise with respect to financial institutions.

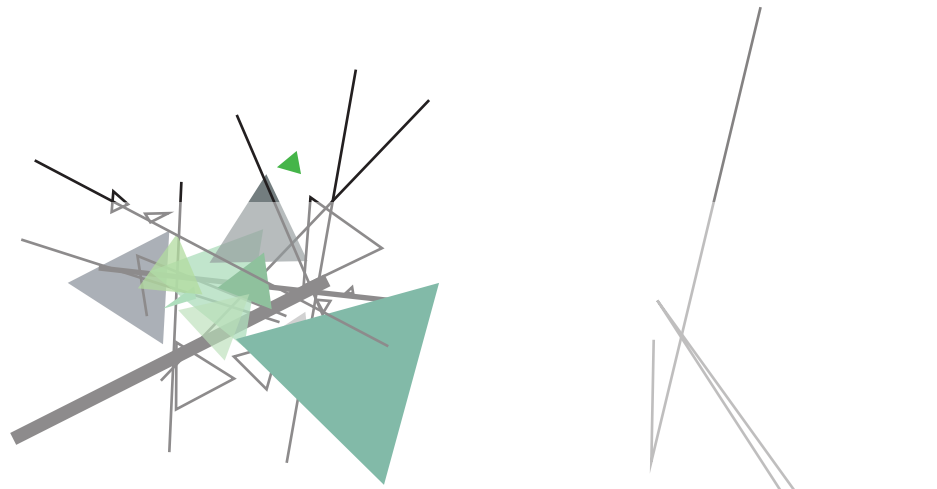
However, according to the current narrow interpretation, the Law does not apply to debt buyers.

In parallel with the amendments described at 3.1 above, the Law should also be changed to ensure customers retain any statutory rights they have in the event their debt is sold to a third party by the original financial institution.

Additionally, the Law should also require debt buyers and NPL servicers to carry professional liability insurance, as lawyers and professional enforcement officers already do, to ensure consumers can collect due compensation if their rights are violated and they suffer damage.

The Law should also broaden the scope of regulatory powers held by the National Bank of Serbia to ensure individuals whose debts are purchased by debt buyers can receive the same protection currently afforded to bank clients.





### 3.3 Introduction of personal (consumer) insolvency and insolvency administrators for private individuals

As noted above, in 2015 the level of NPLs exceeded 5 bn euros, much of which appeared to be secured by personal guarantees of private individuals (owners, beneficial owners, and directors of the borrower companies) who have little or no instruments available to restructure their debt. As such, it seems pertinent to consider introducing personal (consumer) insolvency into the Serbian legal system.

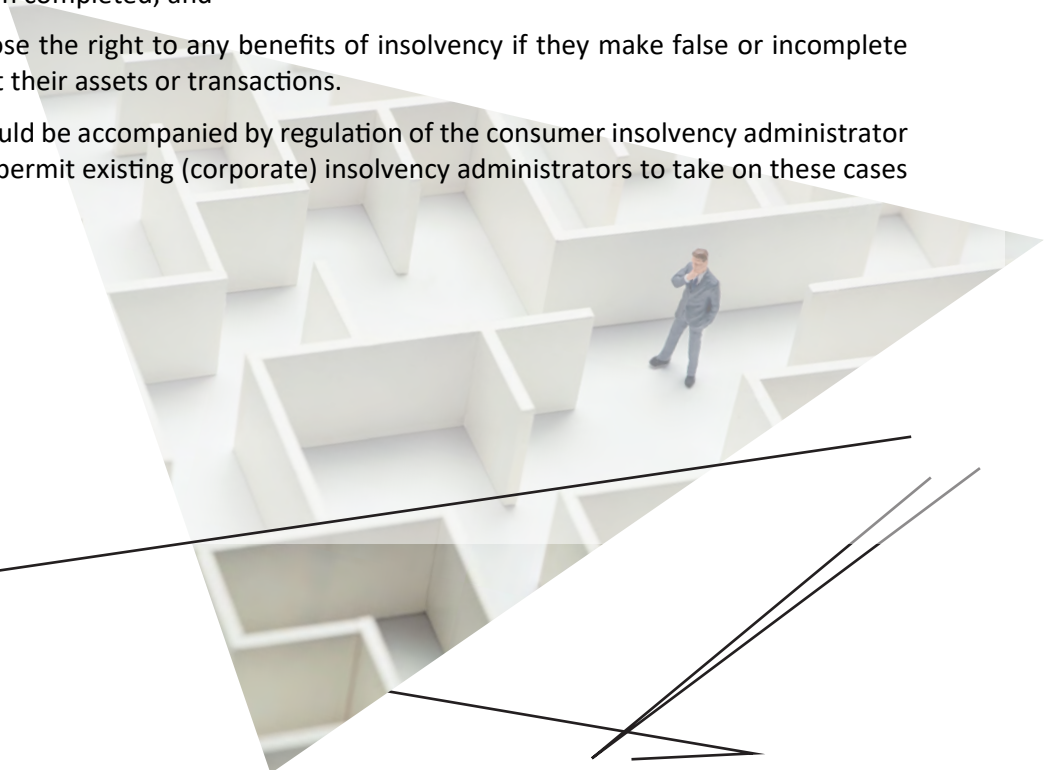
In the EU, personal insolvency is governed by Council Regulation (EC) 1346/2000, as recast by Regulation (EU) 2015/848 of the European Parliament and of the Council; both of these pieces of legislation have been transposed into national law of EU Member States.

Serbia is currently considering introducing sole trader insolvency. This would in effect give preference to sole proprietors over other natural persons who find themselves in the same legal and financial circumstances, either as guarantors (mainly for their businesses) or consumers.

In parallel with contemplating sole trader insolvency, the country should also consider introducing general consumer insolvency, with the following features:

- the debt threshold required to trigger insolvency must not be set too low (for instance, it should be at least 50,000 euros);
- the procedure would have to ensure the debtor is completely discharged after completing the process;
- the procedure would have to be fast, clear, efficient, transparent, and affordable, and all stakeholders would have a distinct obligation to adhere to these principles;
- there would have to be a ban on filing for or conducting an insolvency proceeding before a prior one has been completed; and
- debtors should lose the right to any benefits of insolvency if they make false or incomplete statements about their assets or transactions.

Consumer insolvency should be accompanied by regulation of the consumer insolvency administrator profession, which would permit existing (corporate) insolvency administrators to take on these cases as well.






#### 4. Conclusion

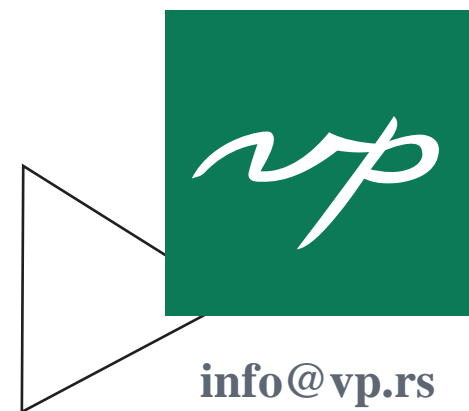
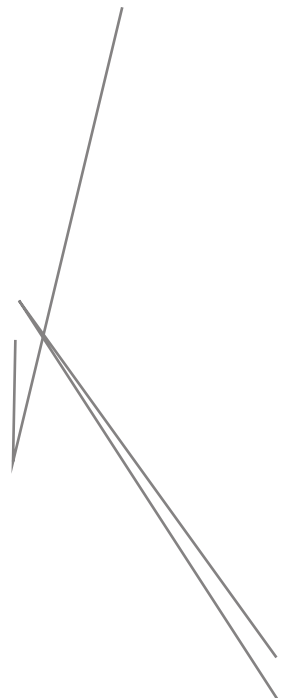
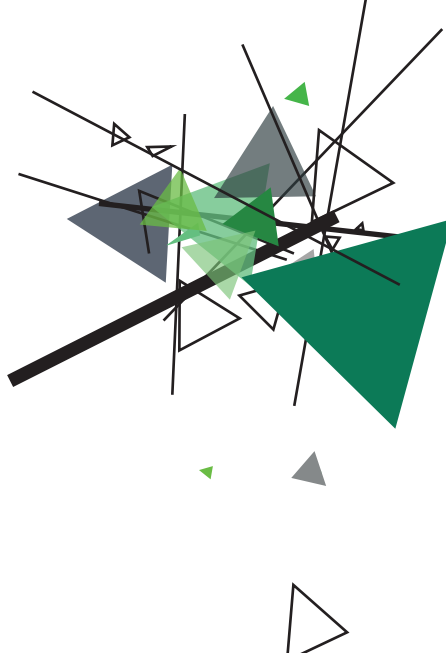
The proposed solutions are neither new nor unknown to other jurisdictions, since they have been successfully implemented throughout the EU and in most neighbouring countries. They have to some extent already been recognised in the Strategy and have been the subject of debate within Serbia, both in the expert community and by the public at large.

The key risk is that the format and details of the proposed solutions end up defeating the purpose of the measures.

Montenegro and Romania are two countries where this risk has materialised: there, the legislation has created a framework that entirely disincentivises debt buyers from entering the secondary NPL market, making the reforms pointless (the key is finding the right balance so that legislation is sufficiently flexible to avoid imposing excessive barriers for entry and fixed costs on investors in small markets with limited economic potential). Instead of being a step in the right direction, arrangements seen in these countries would set the economic and regulatory environment back by years. Similarly, recently advanced proposals for consumer insolvency – which did not envisage complete discharge of debt for individuals emerging from bankruptcy – would utterly defeat the purpose of this procedure.

Nevertheless, regardless of the risks involved, it seems that these features would bring substantial benefits to a broad range of stakeholders, and it is clear that their introduction must be accelerated.





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