

ECJ judgement averts worst-case scenario for investors in Spanish NPLs



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The European Court of Justice's (ECJ) March 26 judgement on early-termination clauses in Spanish consumer mortgage contracts averts the worst-case scenario for investors in Spanish NPLs.

The course of foreclosure proceedings related to mortgages to individuals has been subject to increasing uncertainty in recent years, as the Spanish courts have declared that several standard mortgage contract clauses traditionally applied by banks were abusive and should be considered null and void – with retroactive effect. Increased litigation resulting from this has contributed to a doubling in average foreclosure timings in Spain from around 1.5 years in 2004-2010 to around three years in 2017-2018.

One of the most controversial aspects has been the application of early-termination clauses. According to the new mortgage law (Ley de Crédito Inmobiliario), a lender must wait until 12 or 15 installments have been missed¹ before initiating foreclosure proceedings. In the past, many contracts had allowed termination after just one unpaid installment. Since this practice was declared abusive, there has been increasing uncertainty about the course and length of foreclosure proceedings regarding consumer mortgage loans subject to such abusive clauses.

ECJ sentence on abusive early termination clauses

The fundamental question is whether recovery proceedings that had been stayed by Spanish national courts, as early termination clauses were declared abusive, can continue through mortgage foreclosure proceedings, or if creditors need to turn to ordinary recovery proceedings, which could take much longer.

For early-termination clauses to grant access to mortgage foreclosure proceedings, they must be included in the mortgage loan contract. The ECJ judgement shed some light on the following key questions regarding contracts which were terminated based on early-termination clauses declared abusive, even if most elements remain inconclusive (see Figure 1).

Question 1: Can an early termination clause be partially modified by removing the elements that make it abusive (for instance, extending the minimum time in arrears that gives the lender the right to terminate a contract), or should it be fully removed from the contract?

Answer: The clause must be fully removed from the contract, as the option to modify the clause without further consequences would contravene the goal of European consumer protection directives, which is to discourage the use of abusive clauses.

Question 2: Provided the contract cannot survive without the early-termination clause, should mortgage foreclosure proceedings be dismissed, even if ordinary recovery proceedings could be more detrimental to borrowers' interests?

Answer: If the judge determines that the contract cannot survive without the early-termination clause and that the effect of invalidating the contract would be detrimental for the borrower, the judge would be able to rule on the replacement of the early-termination clause by a supplementary disposition compliant with national regulation. This would enable the continuation of mortgage foreclosure proceedings. The ECJ's judgement established that it falls to national courts to determine what recovery procedure is considered more protective of borrowers' interests.

¹ Depending on whether the non-payment occurs during the first half of the life of the loan or during the second half of the life of the loan

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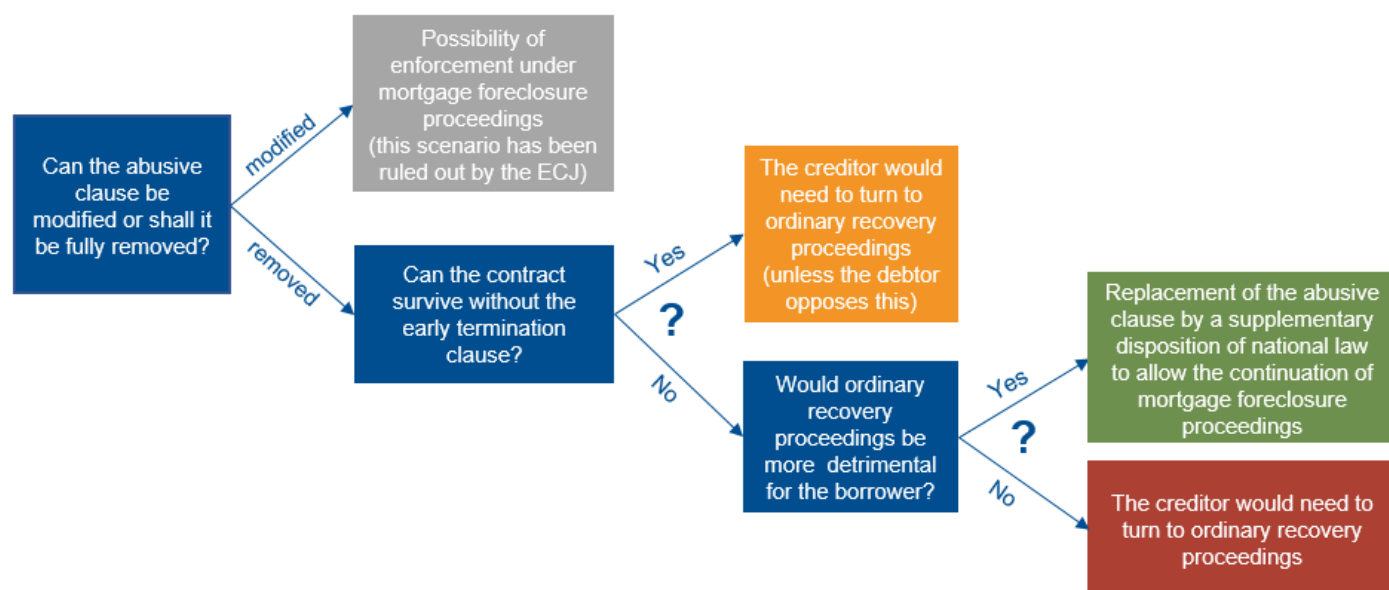
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Figure 1: Consequences of abusive early termination clauses according the ECJ sentence



Source: Scope Ratings

Uncertainty remains but worst-case scenario is held off

Speed of recovery is paramount for investors

The speed of the process is paramount for investors, because lengthy procedures erode the net present value of expected recovery proceeds. This is due to various factors which feed off each other: a) the time-value of money, b) an increase in the investor's required rate of return due to the cost of uncertainty c) the build-up of procedural and legal expenses, and d) higher risk of collateral depreciation.

The worst-case scenario for investors is averted...

The ECJ explicitly stated that it does not oppose the continuation of mortgage foreclosure proceedings if the judge considers that the contract cannot survive without the early-termination clause and that ordinary proceedings would be more detrimental for the borrower. In Scope's view, opposition would have been the worst-case scenario for NPL investors, since all creditors affected by the declaration of the abusiveness of early-termination clauses would need to turn to ordinary proceedings, which potentially take much longer.

...but uncertainties about the effect of removing abusive clauses have not been solved

However, the legal consequences of removing an abusive clause remain subject to the discretion of the judge; therefore, there is still uncertainty around the course and duration of ongoing recovery procedures (see Figure 1).

It is unclear which procedure is more favourable for borrowers

A judge may rule in favour of ordinary proceedings, considering the potential benefits to the borrower of a) postponing the eviction process, and b) broadening the grounds of opposition. However, a judge may alternatively consider that mortgage foreclosure proceedings may provide a higher degree of protection to consumers. For instance, if the mortgaged property is the borrower's main residence, (a) there are relatively high minimum guaranteed auction bid prices, (b) the borrower can obtain partial reductions in the outstanding debt if the amounts due are not fully covered by the proceeds from the auction, and (c) even after the filing of the claim to foreclose the property, the debtor is entitled to cure his default by depositing the due amount.



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