NPL resolution: prerequisites for loan portfolios sales in the CESEE region

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The non-performing loan (NPL) market in CESEE region has gained momentum during 2015 with an increase in portfolio sales due to a growing number of lenders considering portfolio disposals and international distressed asset investors actively looking into the region in search for yield. In the last year alone, loan sales of about EUR 4.5 bn book value were closed.[2] *Despite such encouraging developments, an almost equivalent notional volume of NPL sales were not completed during 2015 and the sales that did happen were concentrated largely in three countries. This note focusses on some of the key factors that have contributed to the development of the secondary market in NPLs and highlights the challenges that such transactions still face, in particular in the corporate/SME segment where the NPL problem is most acute.*

1. RECENT NPL SALES IN CESEE

The improvement of economic conditions in 2015, coupled with an increase in provisioning following the AQR exercises in several of the CESEE countries, has served as a catalyst for NPL sales in the region. In parallel, authorities and regulators across the region have prioritised the establishment of strategies towards NPL resolution. Recent examples include the comprehensive "*NPL Resolution Strategy*" and detailed "*Action Plan*"[3] published by the Serbian authorities; a policy strategy paper for Slovenia containing a section on "*Solving the non-performing loan problem*"[4]; a series of proactive steps and recommendations established by the National Bank of Romania aimed at supporting the sustainable resolution of NPLs in the banks' balance sheets[5]; and the recent set up of a bank asset management company in Hungary (MARK).

Against this background, banks in the region have been actively working towards reducing the NPL ratio through a *dual-track process: (i)* organically, by stepping up efforts on internal workout and resources allocated to corporate recovery units; and *(ii)* by identifying portfolios that can be sold in the market and subsequently launching sales processes when possible. A number of market transactions have been successfully closed over the last 18 months (please see figure 1) with further deals currently on-going in these markets. A few observations can be drawn from the recent experience in the market for debt sale in CESEE:

- In ***Romania***, one of the most active markets in the region, there has been continued activity on disposals of distressed assets portfolios mainly driven by subsidiaries of larger European banking groups.
- In ***Slovenia***, where the NPL problem is mostly related to corporate lending, transactions have been closed for less granular portfolios, including a disposal from the Slovenian Bank Asset Management Company (DUTB) on claims on four companies.
- ***Hungary*** has also registered transactions on individual assets with the first ever sales of syndicated Commercial Real Estate (CRE)-backed loans.
- ***Poland*** has a more mature consumer loan NPL market - the corporate NPL has seen some increase in activity, though it is still relatively undeveloped.
- In ***Bulgaria*** some activity was registered in consumer loan portfolios.

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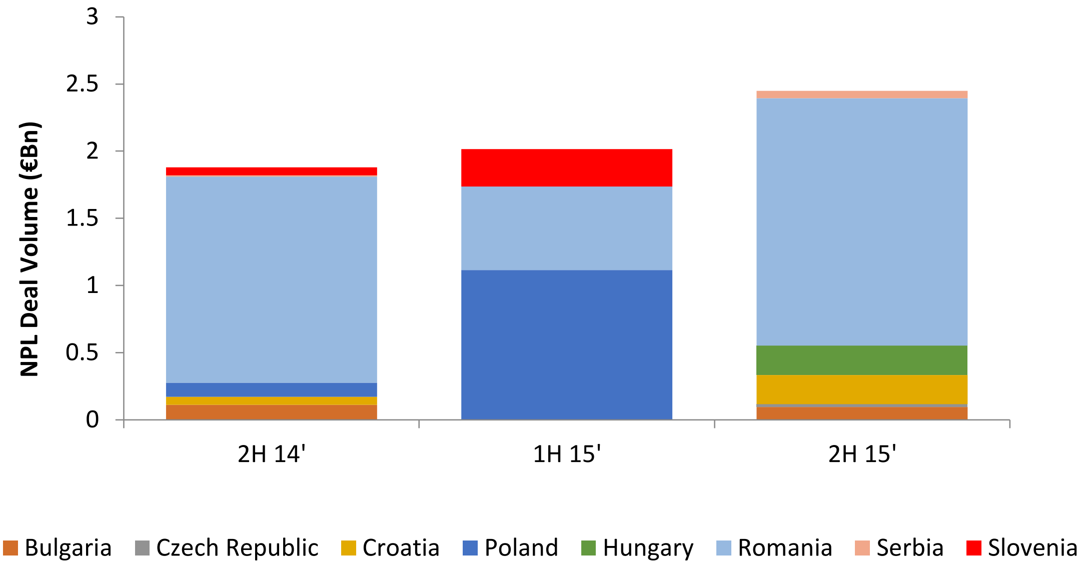
[2] "NPL Monitor for the CESEE, June 2014 to December 2015", EBRD, March 2016
[3] "*NPL Resolution Strategy, Executive Summary and Action Plan*" http://www.mfin.gov.rs
[4] "*Policy Strategy Paper for Slovenia, 2015*", December 2015, https://www.bsi.si/en/
[5] "*NPL Resolution: the case of Romania*", Vienna Initiative note, March 2016, F. Montes-Negret and Eric Cloutier

- ***Serbia*** has seen sales for smaller portfolios containing mainly SME/Corporate loans.

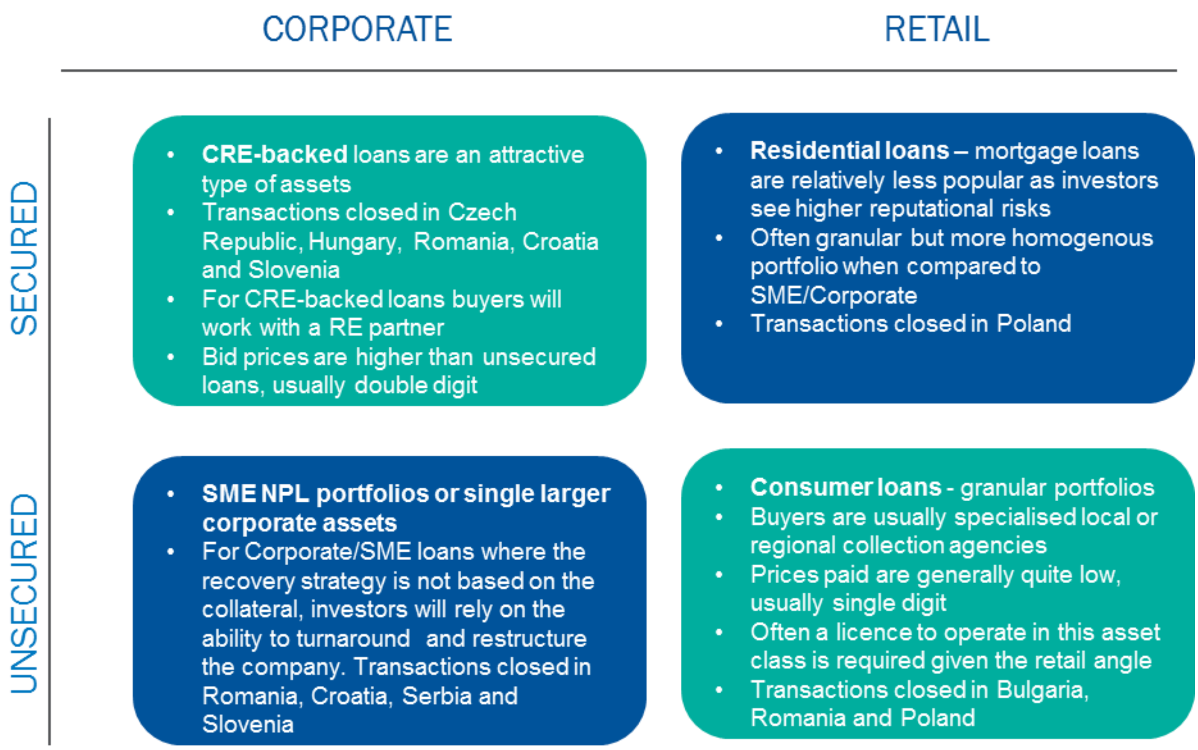
Figure 1: NPL Deal Volume in CESEE



Source: KPMG Analysis, Debtwire, EBRD analysis

Distressed asset investors have focussed on the CESEE region as potential yields are attractive on the back of an economic recovery and given that more deals being offered in the market**.** Investor interest tends to favour either commercial real estate backed corporate loans or unsecured retail loans. The assets underlying NPL sales in the region during 2015 have therefore included retail/consumer loans and CRE- backed loans but also corporate/SME portfolios, often offered as a mixed pool of performing and non-performing exposures. Having a performing portion in the pool may make the portfolio more attractive as the initial cashflows can be used to provide cash to invest in the other non-performing assets that need remedial work. Some transactions have been purchased through a consortium of investors with international investors complementing their expertise with local or regionally-focussed debt managers and collection agencies.

Figure 2: Underlying asset classes to NPL transactions in the CEE



Based on the transactions in the CESEE countries to date some patterns have emerged in the different asset classes:

- For ***unsecured retail loans*** the recovery process is mostly based on an efficient collection service and restructuring of debt, which can be particularly fruitful in the context of an economic recovery. Such transactions are often seen as a good stepping stone to new markets as investors can leverage on services provided by local collection agencies.
- ***Residential loans/Mortgages*** may be less attractive to investors due to the stricter regulation usually linked to this type of asset class, making enforcement and collection more challenging.
- For ***corporate/SME loans secured by commercial real estate*** buyers will value the claims on the basis of a detailed valuation exercise on the underlying collateral with the assistance of real estate (RE) experts. Factors such as liquidity of RE market and efficiency of foreclosure and enforcement process will be taken into account to adjust the price. Economic recovery will still play an important role as the underlying real estate asset can be either sold or put for rental in order to generate cash flows. Portfolios can be relatively granular though investors will more likely be attracted if such pools contain a few easily identifiable real estate assets.
- For ***other corporate and SME loans***, which are either unsecured or where the workout strategy is not defined by the collateral, investors will focus on the ability to turn around and restructure the underlying company, in particular if the business is producing some cash flows. This can be a more challenging process than purely managing the underlying collateral as often distressed companies need additional funding to recover to a 'going-concern' basis. The ability to effectively take control of the company through the debt claim and/or being able to 'cram down' minority claim holders may therefore be important for the buyer of such claim. As such, pricing will take into account the regulatory and legal environment and super-seniority of any eventual additional funding, in particular in case of insolvency. For corporate portfolios, investors will often concentrate on larger single assets, which can provide attractive returns by being restructured on a selective basis through a corporate recovery vehicle. The recovery process of such claims will usually require turnaround experts, legal expertise for restructuring of companies and a longer workout process with a more

hands-on approach relationship with the borrower. Third party expenses tend to be also higher in this case.

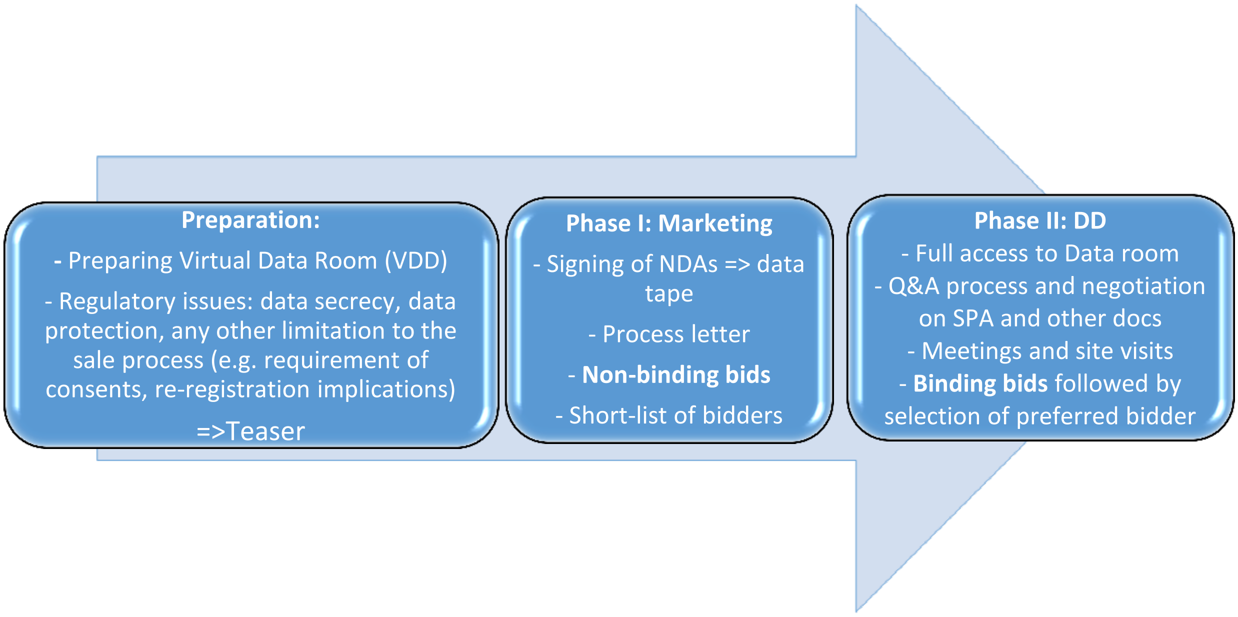
2. OBSERVATIONS AND LESSONS LEARNED

Despite the encouraging signs within the CESEE debt asset sale market, an estimated EUR 4bn of distressed sale transactions did not close in 2015.[6] The pricing gap is often mentioned as a cause for transactions not completing. However price divergences may also reflect the discount applied by investors due to specific issues such as poor quality of data, illiquidity of real estate market or inefficiencies in the insolvency law or generally the need to achieve a higher return. From the recent experience in the region the following factors are important in a successful NPL transaction:

I. The disposal process needs to be well-organised, and underpinned by good quality data

Most transactions closed were executed through a competitive **auction process** managed by an adviser with experience in NPL sales. The auction process gives some reassurance to the seller that bid prices are being potentially maximised, offering also the opportunity to different investors to bid on the assets in a fair, competitive way. The sale should be managed based on high quality data provided to investors to enable them to make a solid credible bid. The most common process used in these sales has been a two-stage bid preceded by a data preparation phase.

Figure 3: Timeline of the loan portfolio marketing process



- The **preparation** phase includes the selection of the portfolio for sale and gathering of all the relevant information underlying such assets. A "teaser", i.e. a short document containing the key facts of the transaction, is then sent to target investors. Following the teaser, interested investors will sign a Non-Disclosure Agreement (NDA), which will allow them to receive further information on the portfolio usually through a detailed data tape[7]. **Phase 1** is usually completed with the receipt of non-binding bids which will allow the Seller, together with input from the adviser, to select the potential bidders for Phase 2.
- During **Phase 2** potential investors engage in intensive due diligence and analyse the portfolio. All information and respective documentation is downloaded to a virtual data room. During this phase

[6] Source: "*NPL markets gathered momentum - Full steam ahead*", November 2015, Deloitte; EBRD analysis
[7] A strict NDA is needed as data contains sensitive information on the underlying borrowers.

potential investors can ramp up considerable costs related to legal fees, real estate valuation commissions and other expenses. They are therefore very selective before spending further time and resources. The outline of the Sale and Purchase Agreement (SPA) should also be negotiated at this stage though the final terms are often only fully negotiated post selection of the preferred bidder. In parallel to the analysis of the portfolio, the potential buyer may seek to line up the servicing capacity[8] and workout experts as well as set-up any Special Purpose Vehicle (SPV) on or off-shore for the purchases of the portfolio.
- The **final phase**, the closing of the actual transaction, can take several months as the actual claims are transferred, the structure for the purchase is set up and the SPA is finally signed. Often provisions about retaining cashflows on the underlying assets between the bid and closing date are negotiated by the buyer.

The quality of data and completeness of legal documents is crucial for a fair valuation. For instance, documentation should prove that ultimately the claim is enforceable. Banks in a sale process should review the information and avoid any disparity or inconsistency, which would raise risk premia sought by investors. This is a particular concern for commercial real estate, which often suffers from a lack of comparables in the market or insufficient information to build assumptions on fair valuations of collateral. Unreliability or lack of proof of rent rolls will also lead investors to include conservative haircuts on CRE collateral valuation.

Ensuring that credit and loan officers are prepared and available during due diligence is therefore imperative: staff should be well briefed and available to answer questions promptly including on fraud issues, 'Know Your Customer' due diligence and any outstanding litigation. During the preparation phase the seller should identify any regulatory or legal issues that could be an obstacle to the sale and transfer of assets. For example, a licence requirement or the need to request permission from borrowers upon assignment of claims will weigh on the investors' risk perceptions, and ultimately on the number of bidders interested in the transaction. Another important aspect of the preparation phase is to understand local data protection and bank secrecy regulations and respective implications in terms of the bank's burden on confidentiality of information. As a precaution, sellers opt to put in place strict NDAs and a gradual disclosure process to control the amount of protected information that is made available.

II. Establishing the right dynamics between buyer and seller

Given the intensity of the due diligence for management and staff of the selling bank it is important to select a small but credible number of bidders. Investors will shy away from an auction process that is open to a large number of bidders. Targeting the right buyers is essential to a successful sale process of a specific portfolio as distressed asset investors will often focus on a particular type of asset and build their expertise and track record around it. Ultimately, price may not be the only variable determining the final choice of the winning bidder. Credibility and reputation of the buyer as well as assurance of capacity to fund the transaction are often equally important.

On the seller's side, a message on the commitment to the transaction is very important to the potential buyer. Cancelled transactions in the region have made investors more cautious ahead of spending considerable time and resources on due diligence. Often investors have alternative options for investments at equally attractive yields and limited resources. A clear message by the seller to make reasonable efforts to complete the transaction is important to gauge investor interest.

III. Support from regulators and government in removing structural obstacles will instil investor confidence

[8] Servicing capacity may not be easily available at a local level so it may be useful if the seller proposes a solution (e.g. offers to transfer part of the existing work-out team).

Given the challenges around sales processes, the on-going work done by the authorities to identify and remove obstacles to NPLs sales is generally welcomed by investors. Issues such as lack of tax incentives upon loan transfer or write-offs or legal uncertainties related to the bankruptcy and insolvency law are obstacles to the development of the distressed asset market.

The gradual removal of such obstacles as well as development of alternative solutions for asset transfer, such as securitisation, can provide impetus for market development. Several authorities across the region have elevated NPL resolution in their respective agenda, underpinned by more stringent supervision. National action plans or NPL resolution strategies will inspire confidence that a coherent effort is made across all parts of the government, and regulatory authorities.

3. Conclusion

The sale of certain types of distressed loan portfolios should be a crucial component of banks' efforts to return their balance sheet to health, though it is no *panacea*. Ultimately it is equally important that banks combine these solutions with continued in-house workout and other solutions (such as third party workout platforms) to maximise results in the NPL resolution process.

An NPL portfolio sale can however attract investors with much needed specialist restructuring expertise, and put the relationship with a distressed borrower on a sounder footing. 'Moral hazard' among borrowers that may have expected further forbearance by their lenders is less likely and a strengthened credit culture may underpin a recovery in bank lending.

The market for distressed assets suffers from an inherent information asymmetry in which the true asset quality and prospect for a restructuring and value recovery are difficult to discern ex-ante. These obstacles are doubly daunting in the financial systems of the CESEEs countries, where institutions for collateral assessment and information sharing are often under-developed. Loan sales pose a number of issues in prudential supervision, and the governance of new loan servicing entities remains a focus for regulators across the region.

It is therefore encouraging that a number of governments and regulators seek to facilitate sales processes, and that new investors are taking an active interest in the CESEE. The greater dynamism of the market in 2015 could be an early sign of more sustainable path into NPL resolution for the region.