# Non-Performing Loan Securitisation - Friend not foe

The trends, the changes and the future.

2021

ReedSmith

Driving progress
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Timeline of our thought leadership in this space


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# Introduction

As an international law firm that has been heavily involved in acting for investors, sellers, financiers and servicers of non-performing loans (NPLs) during the meteoric rise of the NPL market from the ashes of the global financial crisis (GFC) then we are only too aware of the profound impact that COVID-19 has had on the global NPL market.

In the space of a few weeks a large, burgeoning market that exhibited a waterfall of transactions was confined to a trickle as deals were pulled or left to stagnate as the market was shrouded with the malaise emanating from the pandemic. Indeed, the erstwhile market observer will be aware that there are a number of significant hurdles that the NPL market will need to overcome in order to properly kick start which includes:

- a recalibration of expectations around the bid-ask price
- the ability to quantify the impact of COVID-19 when it comes to the valuation of NPLs
- the availability of debt finance to maximise returns

As was true with the genesis of the European NPL market in the wake of the GFC, these hurdles need to be surpassed and the sooner this is achieved the better for not only the banks but also the respective economies in which they operate. One major difference to the fallout of the GFC, is that securitisation is likely to play a prominent role in the new NPL order. In fact, when you consider securitisation, the NPL market is at a true inflection point.

On the one hand, we know that there is still significant NPL stock stemming from the GFC and that these levels will only surge once the new crop of NPLs created by the current crisis are factored in. In addition, a significant secondary NPL market, driven by the need to monetise existing NPL portfolios, is also likely to emerge.

Whilst, on the other hand, securitisation technology has improved immeasurably since the GFC, through better regulation, arrangers taking heed of the structural reforms proposed by various industry bodies whilst at the same-time shortcomings in securitisation structures and documentation have been readily identified and rectified.

The Securitisation Regulation has also acted as a beacon of best practice through encouraging and incentivising securitisation structures to be simple, transparent and standardised.

We have long held the view, that the deployment of securitisation technology has the latent potential to play an integral role in the NPL market. Indeed, this was a hypothesis that we first mooted in an article published in October 2014 and since then we have welcomed how the market has evolved and embraced this technology to make a real difference to the NPL market as a whole. Given the current inflection point, we thought that it would be timely to share this publication which contains a number of thought leadership pieces that we have published over the years that track the evolution of the European NPL securitisation market.

Ultimately, as the NPL market moves into a new era, we are very much looking forward to continuing to advise investors, sellers, financiers and servicers on not only the new crop of deals but also the application of securitisation technology to maximise the commercial benefit of these transactions for all.

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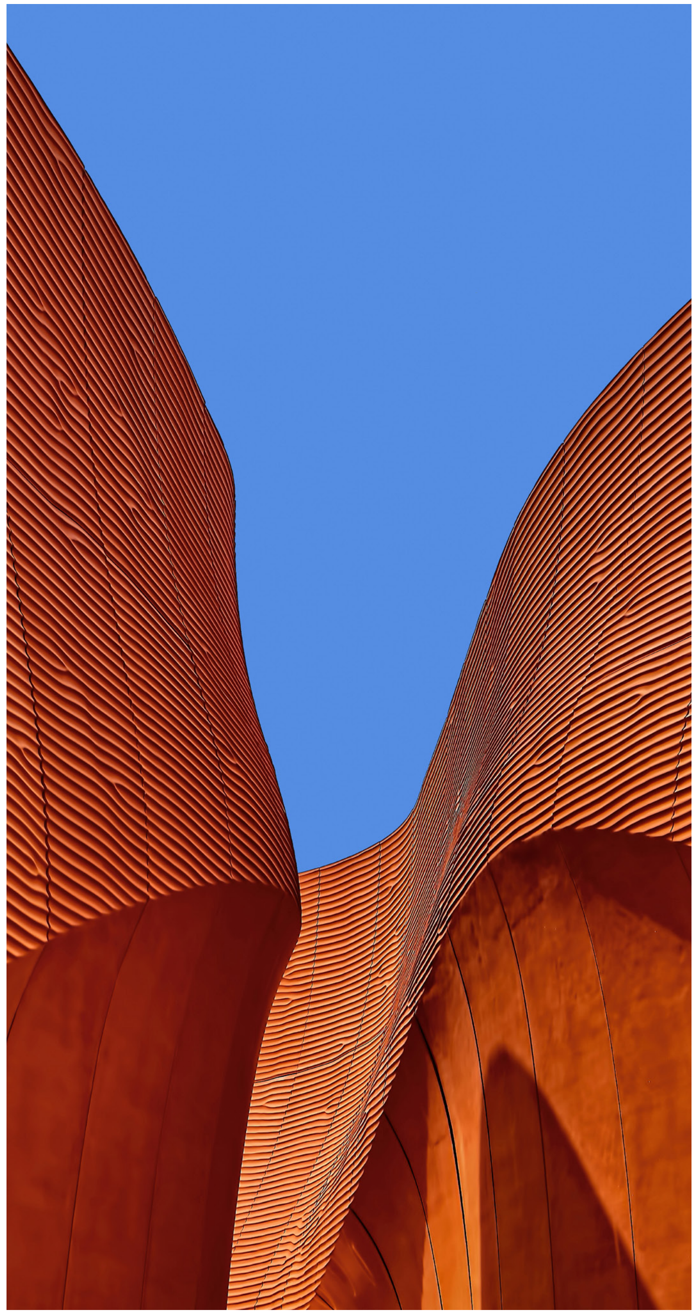
# NPL Securitisation – time for this versatile instrument to shift up the gears!

**February 2021**



The term "NPL Securitisation" has been bandied around a lot recently, and for good reason given the hugely important role it can play in the non-performing loan (NPL) arena.

As banks begin to contemplate life after COVID, they will be acutely aware of the need to neutralise NPLs sooner rather than later. These stockpiles will not only constitute NPLs emanating from the global financial crisis but will also comprise a new crop of NPLs in the form of both COVID loans and those loans that have become impaired as a direct impact of COVID measures on individuals and businesses.

One of the many lessons learnt from the aftermath of the Global Financial Crisis was that the sooner banks off-load NPLs, then the better for not only the bank in question but also the economies in which they serve. It is therefore critical that as world economies begin to unlock there is a concerted effort by banks to address their NPLs on a timely basis rather than kick the can down the road.

All the current hallmarks infer that NPL Securitisation has a critical role in this deleveraging process. On one level this technology can be deployed as a balance sheet management tool, enabling banks to substitute NPLs with securitised notes. However a much more exciting proposition is that instead of a bank retaining NPL Securitisation notes, these are instead sold to third party investors and thus properly distilling the underlying credit risk from bank balance sheets.

At this point in time, NPL Securitisation is certainly being viewed favourably. In Italy the GACs (Garanzia Cartolarizzazione Sofferenze) framework has successfully run for the past five years, and has enabled Italian banks to shed huge volumes of non-performing loans from their balance sheets. More recently over the past year the Greek equivalent (Hellenic Asset Protection Scheme (HAPS)) has demonstrated that it can play a very important role in enabling the Greek banks to divest large amounts of NPLs in one fell swoop. Both these instances of the deployment of NPL securitisation technology have proven to be highly successful and in many respects have created the perfect blue-print for other countries to follow.

The importance of NPL Securitisation in addressing the NPL problem is also acknowledged by the European legislature. Indeed, so-called "quick fixes" to the Securitisation Regulation and the Capital Requirements Regulation are in the process of making their way through the European legislative mill, which will make the deployment of NPL securitisation technology significantly more appealing.

It would be fair to say that the NPL Securitisation market is certainly in its infancy, but drawing on the success of the utilisation of this technology in Greece and Italy and capitalising on the quick fixes to European legislation, this market is set to grow. Indeed, when you consider the potential volume of NPLs and investors current thirst for yield then this could be a hugely significant market.

The potential of NPL securitisation technology though isn't simply confined to banks off-loading NPLs. This technology can be more widely used, and in some quarters it has been surmised that it can be used as a funding tool for so-called Asset Management Companies (bad banks). NPL Securitisation can also play an important role for investors through being used as:

- Source of leverage to improve their internal rates of return;
- A neat tool to either monetise unwanted NPLs or the tail of a portfolio of NPLs that they have largely worked through; and
- An investment vehicle for one or more funds to acquire interests in NPLs.

Whichever way you look at it, NPL securitisation is a highly versatile piece of technology that has massive latent potential. When you consider all this against the backdrop of huge volumes of NPLs, the need to address these promptly alongside some much encouraging legislative treatment (not to mention it's much improved reputation….), then NPL Securitisation is certainly primed to shift up the gears!

*This article was first published in Structured Finance in Brief, 9 February 2021*

End

# Navigating the NPL Securitisation maze

**November 2020**

NPL Securitisation is a term that is very much en-vogue at the present time. Although its rise to prominence can be attributed to a number of factors, in recent weeks the chief contributor has been the European legislature steps towards amending the Securitisation Regulation and the Capital Requirements Regulation. These steps are being taken to ensure that securitisation is better placed to facilitate banks offloading NPL's in the aftermath of the COVID-19 pandemic. In the months and years ahead, the term NPL securitisation will no doubt be bandied around a lot, but what exactly is NPL securitisation? As an attempt to de-mystify this, I thought it would be helpful to give an overview of the different types of structure.

In essence, an NPL Securitisation describes a financial structure whereby an owner of NPLs sell these to a special purpose orphan vehicle that funds such an acquisition by issuing debt securities into the capital markets. The vehicle will in turn appoint a servicing entity that will manage the NPLs on a daily basis with a fee structure that incentivises them to maximise recoveries on the underlying loans. On a broad level such a securitisation falls into two categories:

- Primary Securitisation – which involves the seller (typically a bank) using this technology to remove NPLs from their balance sheet.
- Secondary Securitisation – which involves an acquirer in NPLs using securitisation as a form of leverage to maximise their internal rates of return.

We will now delve into a little more detail with respect to each of these categories of NPL Securitisation.

## Primary NPL Securitisation

Primary NPL structures are rightfully receiving a significant amount of attention from the regulators as this technology has been identified as having the potential to play a hugely significant role in enabling the banks to clean up their balance sheets. There are three divisions of this type of structure.

Third Party NPL Securitisation – here a securitisation structure is used to offload loans from a balance sheet with the resultant issuance being solely subscribed for by third party investors. This is of course the ideal mechanism to transfer problematic credit risk from the banking sector to the capital markets and these transactions will be of increasing importance in the coming years. More information around these types of structure are detailed in articles I recently had published in The World Financial Review (Time for securitisation to be a friend and not a foe of the NPL hit banks) and World Finance (Securitisation – the antidote for non-performing loans).

Retained NPL Securitisation – in this instance, all of the issued notes are retained by the NPL Seller on the basis that they will command a more favourable capital treatment for holding securities in lieu of the non-performing loans themselves. In other words, NPL securitisation is being used as a balance sheet management tool which may also involve a repo.

Government Backed Securitisations – these types of structure constitute the most prevalent type of NPL Securitisation in recent years although only confined to Italy ("GACS" ("Garanzia Cartolarizzazione Sofferenze")) and Greece ("HAPS" ("Hellenic Asset Protection Scheme")). In both jurisdictions, governments have enacted a scheme whereby they provide a guarantee for the most senior class of notes whilst at the same time the junior class of notes are sold to third party investors.

Although these are the broad categories, there are often hybrids of these structures in place in situations where issued securities are both retained by the seller as well as issued to third party investors.

## Secondary NPL Securitisation

As has become customary in the NPL market, leverage has been a key ingredient for investors to boost their internal rates of return on NPLs. The predominant form of leverage to date has taken the form of loan-on-loan financing which has been provided by the seller or a third party bank either on the acquisition date itself or at a later point time. In the context of NPL securitisation what is envisaged is that in lieu of loan-on-loan financing, a securitisation takes place in order to provide a form of leverage. Indeed, if it can be demonstrated that this form of leverage is cheaper and is capable of providing greater flexibility for the investor than otherwise would be the case for a loan-on-loan financing (which I understand is the case), then these are fertile conditions for growth of activity in this space. Similarly, it is worth noting that although not strictly an NPL securitisation, there have been a number of instances in the market where investors have transformed NPLs into re-performing loans and have securitised these.

Based on this canter through the NPL securitisation maze, there are clearly many different types of NPL securitisation which have their own unique characteristics and this is before we factor in the nuances of individual structures such as whether the issuance is listed, rated, public or otherwise. To make matters even more convoluted, given that for the purposes of the Securitisation Regulation loan-on-loan financings are technically classified as a securitisation, market participants frequently refer to these types of financing as securitisations despite the fact that there is no capital markets element.

In conclusion, the NPL securitisation label is extremely broad and although the rise to prominence of this technology can be considered hugely welcome, given the amount of attention these structures are rightfully receiving as well as the infancy of the market, a concerted effort to be properly prescriptive on what NPL securitisation actually means would pay dividends for the greater good of the NPL securitisation market as a whole.

*This article was first published in Structured Finance in Brief, November 3 2020*

**End**

# Securitisation – the antidote for non-performing loans

**October 2020**

With the pandemic continuing to cause intense global economic strain, the NPL market looks likely to swell in volume, and banks must now look at removing these loans as efficiently as possible

Without doubt, the collateral fallout from COVID-19 will herald in a new era for the global non-performing loan (NPL) market, as not only will there be the inevitable surge in NPL volumes precipitated by COVID-19's impact on the economy, but these new volumes will be accretive to the current NPL stock that is residing in the banks as a hangover from the global financial crisis (GFC).

Indeed, as the banks commence the unenviable task of picking through their loan book and identifying those NPLs that they must offload, they will also be cognisant of how they do this in a highly efficient manner that maximises returns. In terms of process, although the prime candidate for this will be the hugely successful competitive auction processes that have become an intrinsic part of the NPL market, in practice we are likely to witness securitisation step up to the plate and assume a critical role in alleviating the pain of the banks.

Conceptually, the application of securitisation technology is the perfect medicine for the cleansing of bank balance sheets. In essence, these structures involve a bank selling a portfolio of NPLs to a special purpose vehicle that funds such an acquisition by issuing debt securities into the capital markets. The vehicle will in turn appoint a servicing entity that will manage the underlying loans on a daily basis with a fee structure that incentivises them to maximise recoveries.

The use of securitisation makes a lot of sense. This technology has the capacity to enable a significant volume of NPLs to be removed from the banks in one fell swoop. Given the only limitation in sizing a transaction is the magnitude of the universe of investors that can competitively price and absorb an issuance, then we could be talking about pretty hefty deals. The opportunity afforded by securitisation, of offloading NPLs in either one large deal or a series of large transactions, is infinitely more appealing than the alternate scenario of a protracted period of auction processes, that we have witnessed to date.

Securitisation technology also counteracts one of the major stumbling blocks that has traditionally made banks reticent about off-loading NPLs: the pricing. Although NPL securitisation cannot guarantee decent pricing, it does possess a number of features that load the dice in favour of the banks when it comes to trying to achieve the best possible return.

Given the bounty of benefits, it is hard to see why securitisation cannot play an instrumental role in mopping up the balance sheets of banks. Indeed this is not a new concept and there is precedent for this in the United States, in the late 1980s, when securitisation technology played a key role in enabling the Resolution Trust Corporation to liquidate assets once owned by the savings and loans associations.

Similarly, had securitisation not been perceived as one of the main assailants of the GFC, then without doubt it would have been the perfect candidate to clean up NPLs in the wake of the GFC.

Ten years on, it can now be said that securitisation is a very different beast. Through the actions of investors, regulators and market participants, securitisation structures have now been finessed and structural shortcomings fixed. Furthermore, the recent Securitisation Regulation has encouraged and incentivised securitisation structures to be simple, transparent and standardised.

In summation, given the hugely positive attributes of an NPL securitisation when coupled with the fact that this technology is now 'fit for purpose', then the requisite fertile conditions currently exist for these structures to be deployed at scale to offload NPLs. Indeed, the fact that the governments of Italy and Greece in recent years turned to securitisation for "GACS" ("Garanzia Cartolarizzazione Sofferenze") and "HAPS" ("Hellenic Asset Protection Scheme") respectively, could in itself be construed as a massive endorsement of the role that this technology can play.

Ultimately, since these structures efficiently enable incredible volumes of NPLs to be distilled from the banks, which in turn enables banks to eradicate their NPL issue on a more timely basis, then securitisation should truly be considered the NPL antidote. Banks choose not to embrace this at their peril.

*This article was first published in World Finance, October 5 2020*

**End**

# Time for securitisation to be thought of as friend, not foe of the NPL hit banks

**September 2020**

As the world continues to get to grips with the fallout from COVID-19 and we start to witness the gradual removal of fiscal stimulus measures and government support across the globe, banks will also start to assess the damage to their balance sheets because of the pandemic. It is inevitable that in the coming months there will be a significant increase in the quantum of non-performing loans (NPL's) it will be critical to remove these NPls for the good health of the banks in an efficient and timely manner. Having been stigmatised for the excesses of the past, securitisation has all the positive attributes needed to be a healer of the banks in the future.

The past ten years or so has proven to be a tumultuous period for the banking sector, as banks across the globe have not only gone about repairing the damage inflicted by the global financial crisis (GFC) of 2008 but also learning to operate in its wake. Meanwhile, a myriad of other challenges have graced the sector including a sustained period of ultra-low interest rates, a heightened level of regulation as well as the emergence of a multitude of shadow banks.

In recent years, the banks have certainly had a rocky ride, but their challenges have not all been external. Indeed, one of their major issues has been the presence of significant volumes of NPL's that have caused a real drag on profitability as well as the absorption of valuable internal resource. Inevitably, the neutralisation of these loans has been a top priority and despite there being a number of tools to do this, the most effective method to date has proven to be the disposal of portfolios of loans to distressed debt investors through competitive auction processes.

For the banks, NPL disposals have demonstrated that they are not for the faint-hearted given that these processes are not only time and resource intensive, but also involve banks crystallizing losses through agreeing eye-watering discounts. The corollary of this is that although a bank may be keen to embark on such a deleveraging exercise, the harsh reality is that it is not always in their gift given the need for a strong balance sheet that is capable of absorbing the resultant losses. Inevitably, to facilitate this painful but essential task, restructurings and re-capitalisations have gone hand in hand with these disposals.

Since the GFC, banks have undertaken these disposal exercises at varying paces, which have largely been driven by the jurisdiction of the bank in question, as well as the location of the underlying assets. In recent years, NPL reduction targets set by the European Central Bank have acted as a catalyst in deal flow, the consequence being that certainly in Europe, there has been year-on-year growth of NPL activity as banks have gone about the messy business of realising their losses and trying to reposition their businesses on a more profitable trajectory. Indeed, 2020 was set to be another bumper year for disposals had COVID-19 not caused NPL processes to stop in their tracks or, at best, stagnate.

Although in the short-term COVID-19 has clearly had a profound impact on NPL disposal activity, in the medium to long-term, the pandemic will inevitably generate an entirely new wave of NPLs, as individuals and businesses succumb to the economic fallout from the virus. Those banks that already have a significant volume of NPL stock on their books will no doubt be ruing the prospect of having to address a heightened volume of bad debt.

As COVID-19 NPLs begin to stack up, it is important to be mindful of some of the lessons learnt from the GFC and, in particular, the fact that the sooner banks deal with NPLs, the better for not only their own profitability but also for the greater benefit of those economies in which they operate. In an ideal scenario, a robust and efficient mechanism would be identified to efficiently offload NPLs, restore balance sheets and return banks to a more even keel. Although in some quarters the suggestion of identifying such a mechanism would be considered fanciful, nevertheless it is quite possible that securitisation, as the foe of the banks in the past, could prove to be their friend of the future.

### How does the application of securitisation work in practice?

Conceptually, the application of securitisation technology is the perfect solution for the cleansing of bank balance sheets. In essence, these structures involve a bank selling a portfolio of NPLs to a shell company that funds such an acquisition by issuing debt securities into the capital markets. The vehicle will in turn appoint a servicing entity that will manage the underlying loans on a daily basis with a fee structure that incentivises them to maximise recoveries on the underlying loans.

The use of securitisation makes a lot of sense. This technology has the capacity to enable a significant volume of NPLs to be removed from the banks in one fell swoop. Given the only limitation in sizing a transaction is the magnitude of the universe of investors that can competitively price and absorb an issuance, then we could be talking about pretty hefty deals. The opportunity afforded by securitisation of offloading NPLs in either one large deal or a series of large transactions is infinitely more appealing than the alternate scenario that we have witnessed to date of a protracted period of auction processes.

Securitisation technology also counteracts one of the major stumbling blocks that has traditionally made banks reticent about off-loading NPLs: the pricing. Although NPL securitisation cannot guarantee decent pricing, it does possess a number of features that load the dice in favour of the banks when it comes to trying to achieve the best possible return.

Whereas an auction process will involve just a small handful of investors, debt securities issued by a securitisation can be mopped up by a whole range of investors of varying size and different risk appetites whilst at the same time not having to incur prohibitive levels of due diligence costs. In other words, securitisation expands the universe of investors and, by doing so, will create a greater level of competition which the banks will be able to reap the benefit from through better pricing on issued NPL securities. At a time when central banks are keen to stimulate the economy through increased quantitative easing, whilst at the same time interest rates remain painfully low, then the chances are that there is likely to be plenty of appetite for the product.

By their very nature securitisations are highly bespoke structures and can be tailored in such a way to put a bank's best foot forward to achieve their desired pricing. An example of this is the inclusion of credit enhancement measures (tranching, credit lines, derivatives) in the structure. Through this structuring, risks can be mitigated which in turn will be reflected with improved pricing. Similarly, if a day one discount for the bank is proving to be a tough pill to swallow, then it is quite possible to structure a transaction in such a way to ensure that the bank could benefit from certain performance hurdles being met in the form of receiving some deferred consideration.

## Potential stumbling blocks of NPL securitisation

NPL securitisations do come with their own shortcomings. Indeed, in the aftermath of the GFC one of the major criticisms of securitisation was the profound complexity of many of the structures. These concerns were well-founded and accordingly have not only been addressed in post GFC issuances but the European regulators have actively encouraged such a shift through regulatory measures (such as the European Securitisation Regulation) which actively encourages structures to be simple, transparent and standardized (STS). Although some of these STS aspects certainly hold true for an NPL securitisation, the stark reality is that NPL securitisation structures by their very nature are the complete antithesis of this, with the underlying collateral comprising a massive portfolio of NPLs without a steady payment stream.

The complexity of an NPL securitisation arises from the presence of multiple distressed loans. Given these loans are non-performing and have not been specifically originated for the purpose of a securitisation, it is likely that many of their key payment terms (amortisation profile, payment dates, interest rate provisions and even currency) will vary and therefore have to be harmonised as part of any transaction. In addition, the terms and conditions of the debt securities are likely to feature complex redemption conditions as well as other structural features to cater for varying payment profiles as well as the non-performing nature of the underlying loans.

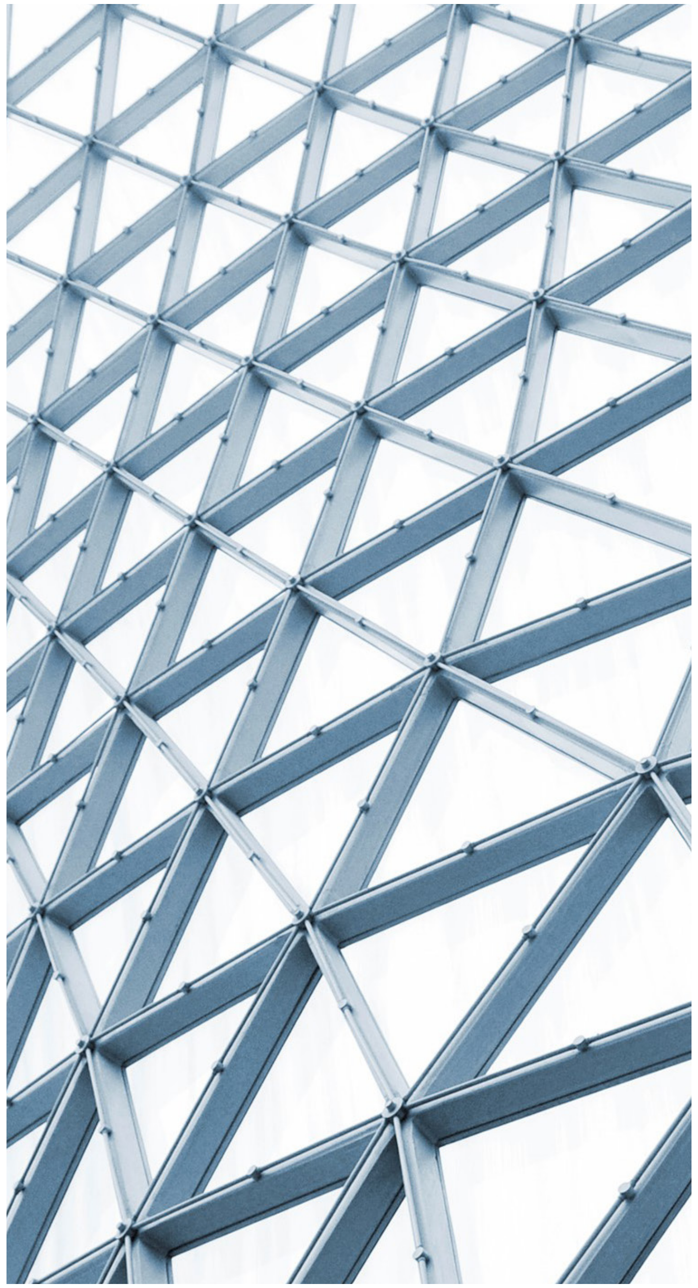
Without question, securitisation does have the potential to enable significant volumes of NPL's to be removed from the balance sheets of banks on an extremely timely basis through the employment of certain structures to achieve the best possible pricing. As for the reservations surrounding NPL securitisations, then none of these are insurmountable and therefore there is no apparent reason why NPL securitisation should not only be actively embraced but should, in fact, positively flourish.

There is also strong precedent that NPL securitisation has been successful in aiding the banks with their NPLs. In Europe through "GACS" ("Garanzia Cartolarizzazione Sofferenze") and "HAPS" ("Hellenic Asset Protection Scheme"), the Italians and Greeks have already successfully harnessed this technology to address those NPLs that have been hampering their banks. We have also witnessed a number of NPL investors successfully utilise securitisation technology as a form of leverage to maximize returns on NPL portfolios that they have acquired. Similarly, if you turn to the United States, there is a strong precedent for this following the establishment of the Resolution Trust Corporation (RTC) in 1989 to liquidate assets once owned by the savings and loans associations. Although the RTC used a range of disposal methods, securitisation technology played a key role in connection with this.

The widespread use of NPL securitisation technology as a means of mopping up NPLs residing in the banking sector certainly makes a lot of sense and the fact that there is strong precedent for this, is living proof that it certainly has a role to play in addressing NPLs. On account of its structural flaws as well as the widespread stigmatization of securitisation, it was inevitable that it had no role to play in the immediate wake of the GFC as a method of offloading NPLs. Just as the banks have gone through a period of rehabilitation, securitisation has also evolved and adapted so that it is stronger, more robust and has already demonstrated that it has a role to play in healing the banks.

Ultimately, time will only tell whether widespread NPL securitisation will be deployed as a weapon to resolve the woes of the banking sector, and with it provide a much-needed boost to the economies that they serve. One thing that is clear, is that the banking sector have a new and enhanced tool to their armory which was not available in the immediate aftermath of the GFC. Given its huge latent potential, and the fact that it has a proven track record as well as the ability to deliver immediate pain relief, then banks risk ignoring this technology at their peril. Securitisation could provide the answer to their woes.

*This article was first published in The World Financial Review, September 25 2020*



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# Can the EBA and Basel Committee proposals help banks clean up their balance sheets using NPL securitisations?

**July 2020**

A large number of legacy non-performing loan exposures (NPLs) continue to subsist on the balance sheets of banks. Portfolios of NPLs tie up huge amounts of regulatory capital which, in turn, limits the amount of capital that banks have available to lend to the real economy. The economic aftershocks of COVID-19 will not only increase the volume of NPL's but also bring into sharp focus the imperative for banks to offload these exposures from their balance sheets. It is highly likely that we will witness an uptick in the securitisation of NPLs in the post COVID-19 economy – but will the securitisation regulation and regulatory capital treatment of such transactions evolve to facilitate this trend? This blog explores the issues with regulatory capital treatment of NPL securitisations under the Capital Requirements Regulation (CRR) and the European Securitisation Regulation (ESR), as highlighted by the European Banking Authority (EBA). In addition, the Basel Committee has recently proposed technical amendments to its securitisations rules text, but will this stimulate the secondary market in NPLs?



## Introduction

European policy makers have looked favourably on the ability of securitisations to allow banks to move portfolios of NPLs off their balance sheets, freeing up regulatory capital reserves and increasing liquidity in the market.

According to the EBA, European banks have managed to halve balance sheet NPLs since 2015. However, despite this achievement, the volumes of NPL's have remained woefully high. Meanwhile, concerns have been raised about the drag in capital as a consequence of the higher 'provisioning' requirements for NPLs imposed by the European Central Bank and the recently approved 'prudential backstop' regulation. Indeed, the recent prudential backstop regulation has sought to introduce a harmonised 'minimum loss coverage' requirement for the amount of money banks need to set aside to cover losses caused by future loans that turn non-performing.

In an effort to boost the NPL securitisation market, the EBA released an opinion in October 2019 (the EBA Opinion) addressing the regulatory capital treatment of NPL securitisations and proposed that capital requirements for such securitisations should be adjusted in order to remove certain constraints on banks considering securitisation structures as a means to dispose of NPL stock.

## Current issues under the CRR and ESR

The EBA Opinion identifies a number of impediments to the securitisation of NPLs under both the CRR and the ESR. It recognises that there are key distinctions to be made between the nature of the securitised risk of 'performing' and non-performing assets. 'Performing' exposures see investors bear the risk of borrowers defaulting on payments (i.e. credit risk), whereas NPLs are already in default and therefore priced on an entirely different basis. More specifically, NPLs are priced based on their outstanding amount and then applying a discount to reflect anticipated future losses and adjusting to take into account the outcome of a workout or enforcement process. In other words, the net value of the NPLs can be said to be the nominal or outstanding value minus the non-refundable purchase price discount (NRRPD). Accordingly, investors in NPL securitisations bear the risk that any workout or enforcement action is insufficient to cover the net value of the NPLs.

## Treatment of NPL securitisations under the CRR

The EBA Opinion highlighted that the securitisation internal ratings based approach (SEC-IRBA) method may result in more favourable regulatory capital treatment at the mezzanine and junior tranche levels of NPL securitisations compared to the securitisation of 'performing assets'. However, when it comes to the most prevalent calculation methods used for regulatory capital requirements for credit risk to an underlying portfolio (i.e., the SEC-IRBA and the securitisation standardised approach (SEC-SA)), these methods produce significantly higher regulatory capital charges for NPL securitisations. In addition, the caps for securitisation capital weightings do not offset the NRPPD from expected losses and the exposure value of the portfolio of NPLs backing the securitisation, which results in disproportionately large capital charges.

**In light of these inequitable positions, the EBA proposes a number of targeted amendments to the CRR including:**

- Defining the scope of 'NPL securitisations' and including, in particular, a requirement that the securitised pool comprise a mandatory minimum level of NPLs from origination/inception.
- The desirable level of the (p)[1] factor for NPL securitisations for the purposes of articles 259(1) and 261(1) of the CRR.
- The inputs to the formulaic approaches (SEC-IRBA and SEC-SA) to better reflect the loss-absorbing effect of the NRPPD in NPL securitisations.
- Using the net book value approach within the securitisation framework when determining attachment (A)[2] and detachment (D)[3] points for the setting of capital requirements for NPL securitisations.
- An appropriate prudential treatment for pools of securitised exposures comprising both performing and NPL's (mixed pools) for the purposes of the securitisation framework.
- The 'expected losses' and 'exposure value' under the SEC-IRBA should be calculated net of the NRPPDs and, where applicable, in the case of the originating institution, additional specific credit risk adjustments (SCRAs).
- Investor institutions be allowed to apply a 100 per cent risk weight cap for securitisations where the originator was permitted to apply the same, and the amount of NRPPD is at least equal to or larger than the SCRAs made by the originator.



## Treatment of NPL securitisations under the ESR

**The EBA opinion makes the following observations in relation to the operation of the ESR to NPL securitisations:**

- As the risk retention amount (for most of the permitted methods) is calculated based on the nominal value of the NPLs, rather than a discounted value which takes account of the loss-absorbing effect of the NRRPD, this may result in an inflated risk retention amount being required to be retained for NPL securitisations.
- The list of permitted risk retention entities under the ESR is too narrow and focused on guarding against the 'originate to distribute' model which excludes other interested parties who may have an interest in the success or failure of a workout process for non-performing assets and so their interests are better aligned with the investors from acting as the risk retention entity.
- The prescriptive credit granting requirements in article 9(3) of the ESR, which require the purchaser of an NPL portfolio to verify that (a) 'sound' and 'well-defined' criteria for credit granting were used by the original lender, and (b) the original lender applied the same criteria to the exposures to be securitised as it did to those that will not be securitised raise particular practical challenges for purchasers of NPL portfolios. For example:
  - The ESR is unclear as to whether an NPL purchaser buying an entire loan book of NPLs is permitted to treat the requirements of article 9(3) as being met – due to no comparable exposures being available in order to assess the application of the 'sound' and 'well-defined' credit granting criteria.
  - Loan books, especially 'performing' loan books, may have been subject to different credit granting criteria at the outset. In other words, a strict application of the article 9(3) requirements could mean that certain NPL portfolios are not capable of being securitised on the basis that no credit granting criteria have been applied to a comparable pool of loans by the original lender.

**The EBA Opinion recommended the following targeted amendments to the ESR framework for NPL securitisations:**

- A specific risk retention amount calculation method for NPL securitisations that takes into account the NRRPD on the assets' nominal value.
- An independent servicer qualifies to discharge the retention obligation where its interests in a successful workout or enforcement process are aligned with those of the investors.
- Article 9(1) and Article 9(3) verification and due diligence obligations are amended in respect of NPL securitisations (and other third party-originated assets securitisations).

### The Basel Committee Technical Amendment on the capital treatment of NPL securitisations

On 23 June 2020, the Basel Committee published a consultation on its proposed technical amendments to the Basel Framework to address the capital treatment of NPL securitisations, recognising the "particular features that distinguish them from securitisations of performing assets" (the Technical Amendment).

### The Technical Amendment establishes:

- A standardised definition of NPL securitisations – where there is a percentage of at least 90% of defaulted assets in the portfolio at the origination cut-off date and at any subsequent date on which assets are added or removed from the underlying pool due to replenishment, restructuring or other relevant reasons. The underlying pool may only comprise of loans, loans-equivalent financial instruments or tradable instruments used for the sole purpose of loan sub-participations. It is noted that national regulators may provide for a stricter definition of an NPL securitisation.
- The introduction of a risk weight floor of 100 per cent for all NPL securitisation exposures.
- The introduction of a fixed 100 per cent risk weight floor for the most senior tranches of non-performing loan securitisations, where the securitisation is a traditional securitisation, and the NRPPD is equal to or larger than 50 per cent of the outstanding amount of the NPLs. The risk weight applicable to other tranches/positions should be determined by the existing hierarchy approaches or the look-through approach.
- A ban on the use of foundation internal risk based approach parameters as inputs for the SEC-IRBA for all NPL securitisations.
- An originator or sponsor bank may apply the current capital requirement cap to the aggregated capital requirement for its exposures to the same NPL securitisation. The same applies to an investor bank, provided, that it is using the SEC-IRBA for an exposure to the NPL securitisation.

The consultation period ends on 23 August 2020, and the proposed amendments are expected to come into effect by no later than 1 January 2023.

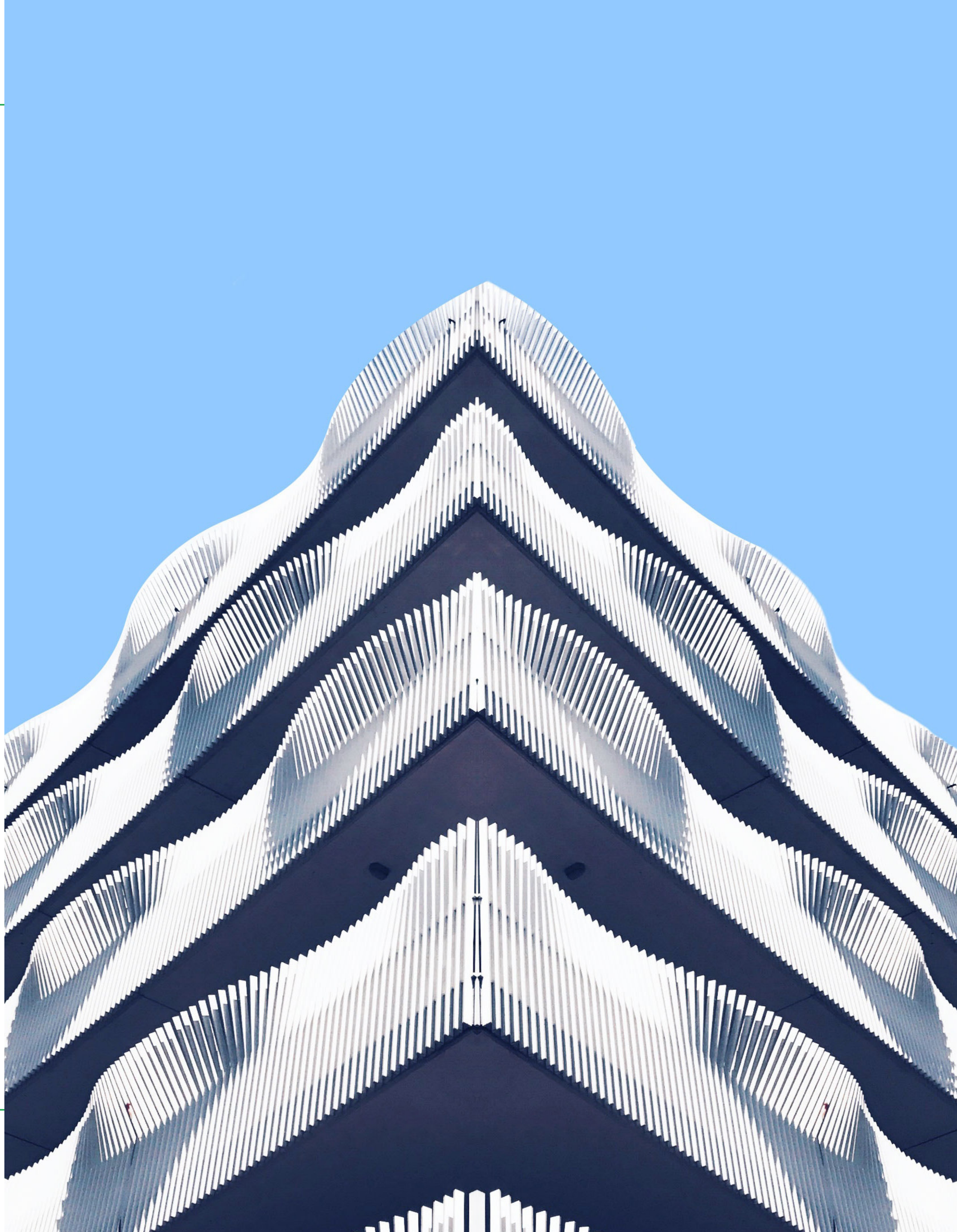
### Conclusion

The EBA Opinion was a much-welcomed first step in recognising certain legal impediments in the existing regulatory framework as they apply to NPL securitisations. The mantle has been taken up by the Basel Committee in relation to the securitisation rules, but work to address all legislative impediments to the securitisation of NPLs is still at a preliminary stage and much more work still needs to be done.

*This article was first published in Structured Finance in Brief, 1 July 2020*

1. *i.e. the supervisory parameter.*
2. *i.e. the input represents the threshold at which credit losses would first be allocated to the exposure.*
3. *i.e. the threshold at which credit losses of principal allocated to a securitisation exposure results in a total loss of principal.*

End



# Hercules – an astronomical boost for NPL securitisation

**January 2020**

The news that the Greek parliament approved the Greek government guarantee programme Hercules marked an important milestone in the evolution of the European non-performing loan (NPL) securitisation market. If Hercules enjoys the same level of success that we have witnessed the Italian GACS deliver, then this will have widespread, positive ramifications for not only yield-hungry investors but also the handful of systematic Greek banks that have balance sheets saddled with large volumes of NPLs.

Indeed, we have long advocated the view that securitisation has the potential to play an integral role in the removal of swathes of NPLs that are currently stifling banks. In fact, the feasibility of such a product was the subject of an article that Iain Balkwill published in 2014 in the autumn edition of CRE Finance World and subsequent articles. Since then we have been delighted to witness how this technology has not only been deployed in the form of GACS, but also actively embraced by trail-blazing funds to maximise returns on their investments.

The fact that the Greek government chose to follow the Italians in deploying this technology could be significant for two main reasons. Firstly, these developments provide yet another rebuttal to one of the chief concerns raised by the 2014 article: that the myriad of structural complexities that needed to be overcome for the execution of a deal presented too high a bar for the beleaguered securitisation market. Secondly, when this new regime is considered alongside the Italian GACS structure, the successful execution of various NPL securitisations that have graced the market in recent years, as well as the commendable efforts of various legislative bodies to put in place the necessary infrastructure to support these types of transactions (such as servicing laws), it would be fair to say that the approval of Hercules can be considered to be the most important stamp of approval yet for deploying securitisation as a solution for NPLs.

Ultimately, only time will tell whether the Greek market will indeed enjoy the same level of success as the Italians. However one thing that is abundantly clear, is that given the incessant pressure on banks to offload significant volumes of NPLs and the fact that Greek legislature has decided to embrace securitisation technology as the tool of choice to achieve this, Hercules has the latent potential to deliver an astronomical boost for the European NPL securitisation market as a whole.

*This article was first published in Structured Finance in Brief, 29 January 2020*

**End**

# NPL securitisation and the trail blazing funds

**May 2017**

The news in 2017 that Blackstone and Lone Star securitized a portfolio of re-performing loans secured by Spanish and Irish real estate respectively, potentially marked the arrival of a new era for the European securitization market. Indeed, if these transactions prove themselves to be the green shoots for the emergence of a new fixed income product, then this has the potential to have widespread positive ramifications for not only yield hungry fixed income investors but also for those banks that have balance sheets saddled with large volumes of non-performing loans (NPL).

Indeed, we have long advocated the view that securitization has the potential to play an integral role in the removal of swathes of NPLs that are currently stifling banks. In fact, the feasibility of such a product was the subject of an article published in 2014 in the fall edition of CRE Finance World (Europe's Future Power Couple – CMBS; A Financing Tool for NPL Portfolios). Simply put, these structures involve the transfer of non-performing (or rehabilitated) loans to a special purpose vehicle that funds such an acquisition through the issuance of notes into the capital markets thus providing lenders (be it debt funds or banks) with a tool for transferring the risk and reward of large volumes of loans.

The news of the successful execution of these transactions by two high profile NPL investors featuring loans secured by assets in different jurisdictions is significant for three main reasons. Firstly, these deals provide a clear rebuttal to the chief concern raised by the 2014 article that the myriad of structural complexities that needed to be overcome for the execution of a deal was too high a bar for the beleaguered securitisation market.

Secondly, when these transactions are considered alongside the Italian GACs structure and the commendable efforts of other European jurisdictions to put in place the necessary infrastructure to support these types of transactions (such as servicing laws), then we could be witnessing the early stages of a paradigm shift towards securitisation as a solution for NPL's (as it has been for so many other asset classes). Finally, the fact that these two transactions have been put together by two major distressed debt investors could be construed as the clearest sign yet that it may in fact be the debt funds (rather than the banks) that will be the key architects of this new fixed income product.

Ultimately, only time will tell if these were the humble beginnings of the establishment of a new fixed income product or whether this is just another securitisation curve-ball. Certainly from a positive perspective, given the incessant pressure on banks to off-load significant volumes of NPLs and the demonstration by these debt funds that securitisation has a role to play in distributing NPL risk, then the news of these deals is a major positive development for the European market. Despite the question marks about the future, those banks that have sizeable volumes of NPLs to shift should follow the lead of these trail blazing debt funds and embrace (or at the very least consider) this technology which has the potential to solve some of their biggest headaches.

*This article was first published in Structured Finance in Brief, 10 May 2017*

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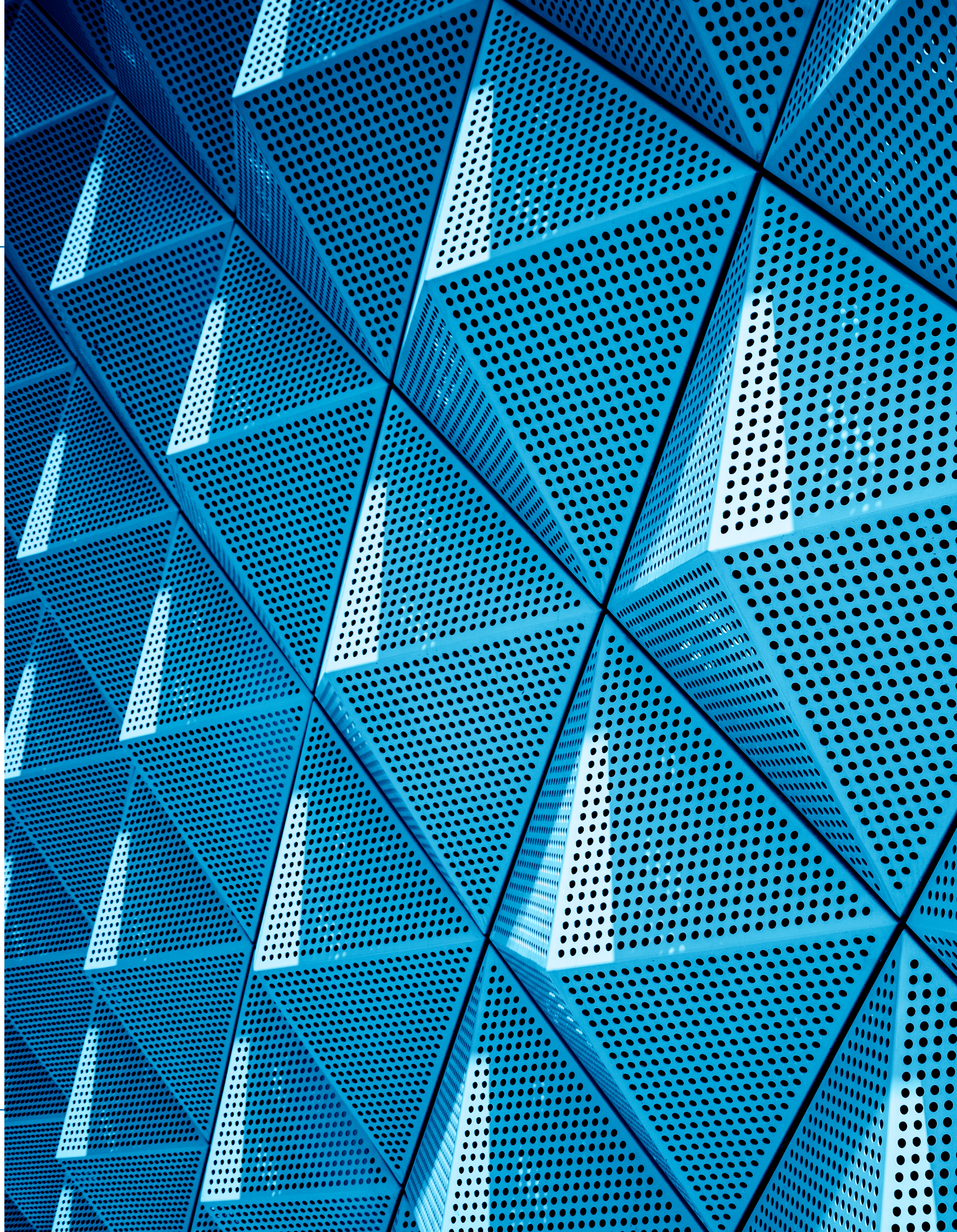

# Italian NPL Market: the tightrope walker and the seagull!

**December 2016**

During the summer of 2016 I wrote about the marvels of the Italian tightrope trick (The NPL Circus: the Italian Tightrope), and remarked on the massive feat of the Italian legislature in making the seemingly impossible, possible, with the establishment of a state guaranteed securitisation structure that is capable of divesting a significant volume of non-performing loans (NPLs) without “bailing in” creditors.

With the news that Prime Minister Matteo Renzi had failed to secure a victory for his “yes” campaign, there will now be a fresh challenge for the Italian NPL market. It is as if a seagull has just dive bombed the Italian tightrope walker, the consequence being a stomach churning wobble or maybe a slip. Although the arrival of this unwelcome guest is rightfully going to be treated by the tightrope walker with disdain, nevertheless the audience should not be surprised as it may be that this is very much part of the trick.

The reality is that the beleaguered Italian banks continue to have astronomical volumes of NPLs that must be off-loaded in order to strengthen the banks and make them more resilient. Nobody said that it would be easy and nor should it be given the complexity of the Italian banking system and the fact that Italian domestic retail investors are so heavily entwined with the banks. By devising the guarantee securitisation structure, the Italian legislature has not only demonstrated that the deleveraging of the banks is a political “must” but that it is willing to implement the necessary legislation required to ensure that the Italian banks fulfil these political aims.

It is fair to say that the results of the Italian referendum and the subsequent resignation of Mr Renzi will no doubt be treated with trepidation given the obvious political uncertainty this creates. However, one thing that does remain certain (and despite the fact that it is a magical time of the year) is that these huge volumes of NPLs are not going to miraculously disappear nor can they just be swept under the carpet. In fact, when it comes to considering the deleveraging of the Italian banks, one cannot help but be reminded of the expression “too big to fail” that was so frequently used at the beginning of the global financial crisis when considering the status of banks. The same can be said of the Italian deleveraging process: it really is too big to fail (without exception) as the off-loading of NPL’s is integral for rehabilitating the banks and therefore the Italian economy as a whole. It is for this reason indeed, that yesterday’s vote should merely be regarded as a wobble and very much part and parcel of the excitement and drama of the trick.

*This article was first published in Structured Finance in Brief, 5 December 2016*

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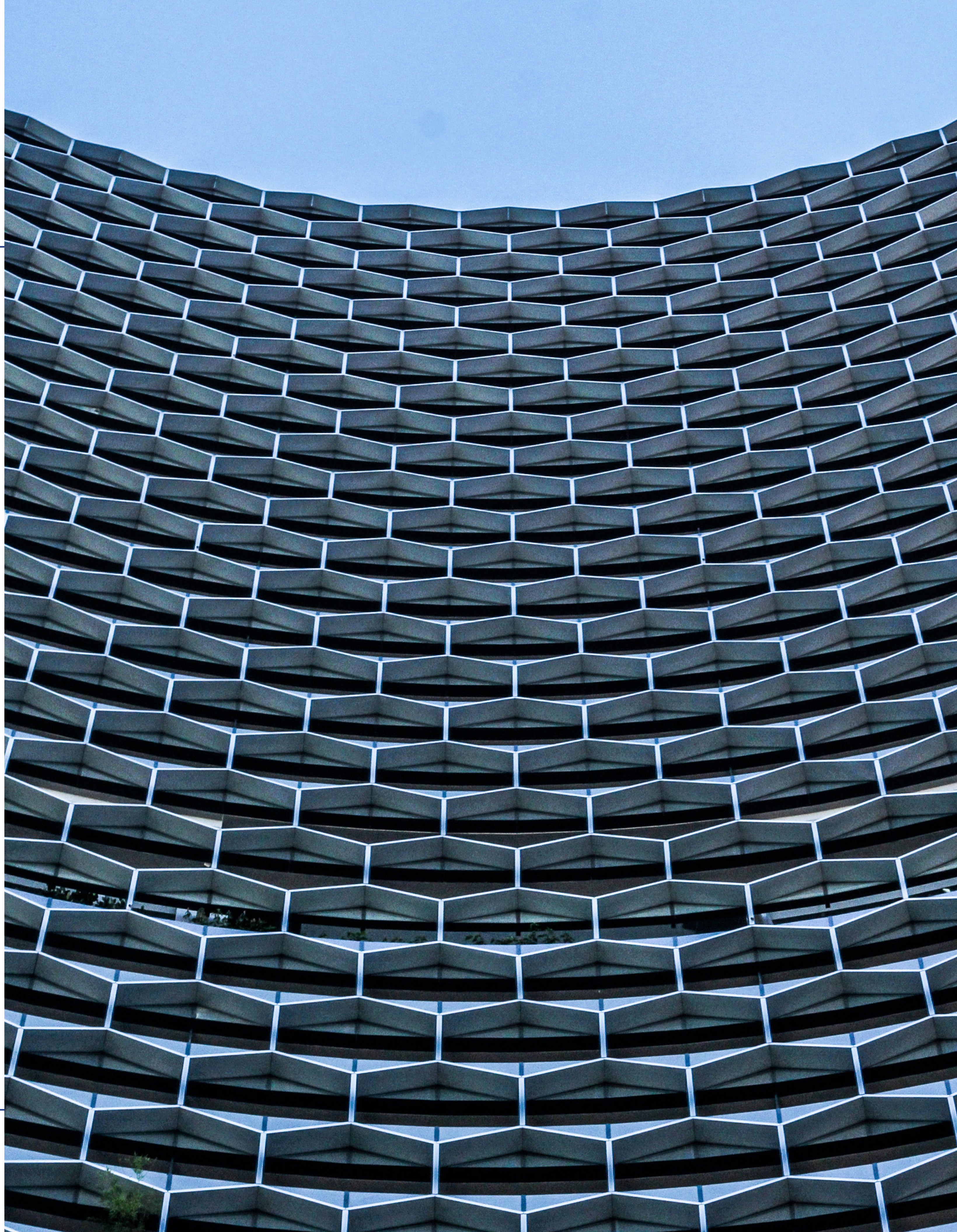

# The NPL Circus: the Italian Tightrope

**August 2016**

In the summer of 2016, fans of the non-performing loan (NPL) circus were treated with the launch of the Italian tightrope trick.

Spurred on by the European Banking Authority stress tests, the news that Banca Popolare di Bari would become the first bank to utilise the Italian state guarantee scheme and deploy securitisation technology as a means of off-loading a €470m portfolio of non-performing loans is a significant step forward for the global NPL market and therefore the NPL circus.

As we noted in Italian reform and the latent potential for CMBS, Italy is certainly the jurisdiction to watch in 2016 and in that vein, we are pleased to see that after months of waiting, the first Italian NPL securitisation will be deployed as a mechanism to address Italian bank NPL anguish. Although the application of this technology could be a huge boost for both the European NPL market and the utilisation of securitisation technology, the realities of whether this will become a commercial success will ultimately be contingent on the pricing of notes. Assuming, that these commercial objectives can be met (and there is every chance that they will be, given that the capital markets are currently awash with low yielding paper) then this is likely to be the first of many deals from the beleaguered Italian market and with it the NPL circus will have a new trick.

The establishment of this structure will be a massive feat for Italyas somehow, the Italian legislature has managed to conjure the impossible: on the one hand they have been prevented from applying state aid to address the NPL issue without "bailing in" creditors, yet on the other hand the "bailing in" of creditors has not been a viable option given that these largely comprise Italian retail investors. In other words, by devising a state guaranteed securitisation structure that is capable of divesting a significant volume of NPL's, the Italians have somehow proven that it is metaphorically possible for someone to walk along a tightrope with their arms tied firmly behind their back and a parrot stood on their shoulder for good measure!

Although admittedly it has taken a while for the first transaction to reach fruition, the fact that Italy has proven that the seemingly impossible is possible, in a world where there is ever increasing focus on those banks that possess sizeable NPL exposures, then it is quite conceivable that from the doldrums of banking woes, Italy has managed to prove that there is a glimmer of hope for those banks and jurisdictions currently struggling under the weight of their NPL's.

As for the NPL circus, it is fantastic news that finally we can watch the long awaited Italian tightrope trick, however as the audience watch with bated breath, we cannot help but think, is this a one trick wonder or a regular addition to the show!

*This article was first published in Structured Finance in Brief, 10 August 2016*

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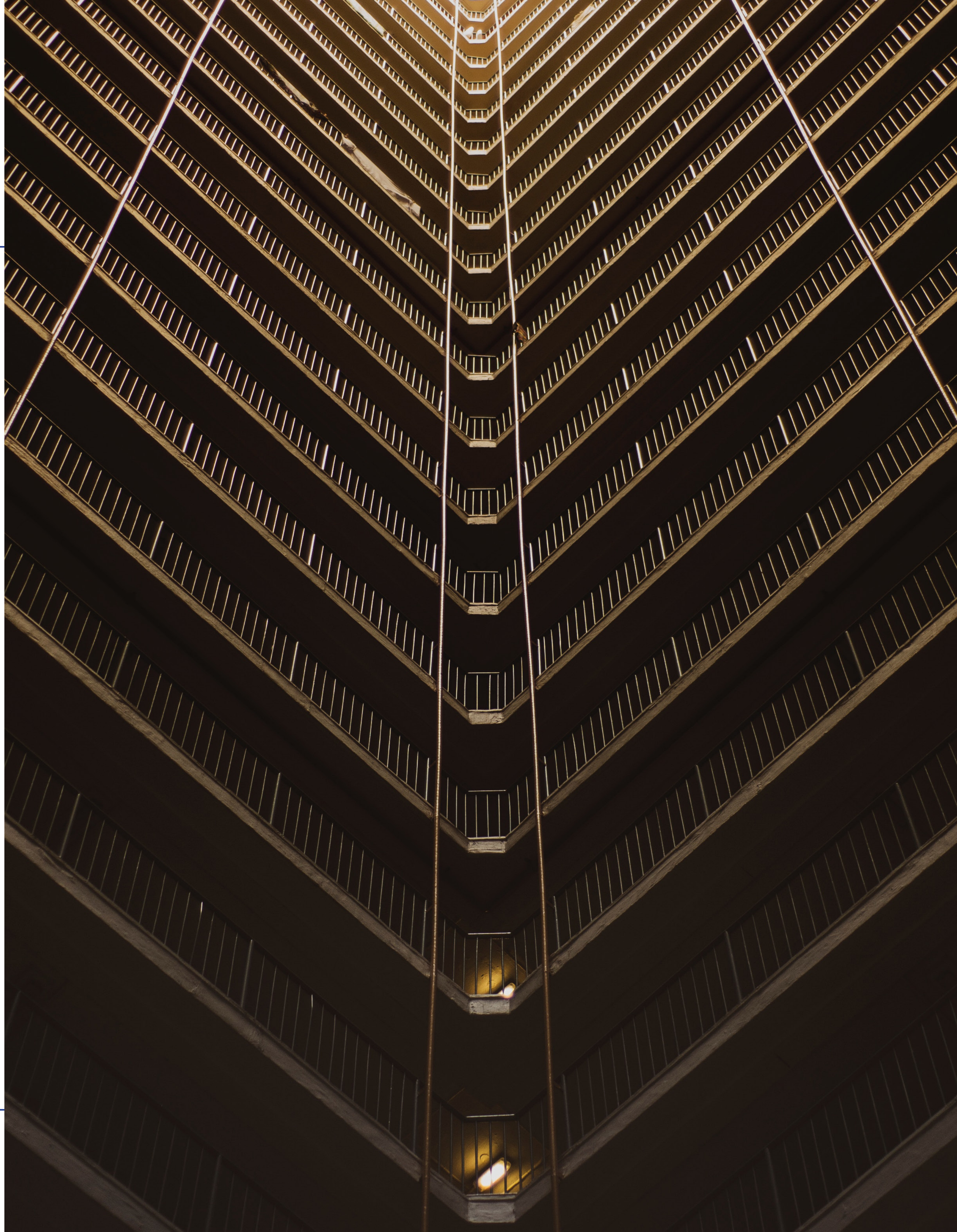


# Is CMBS the answer to Italian bank deleveraging woes?

**February 2015**

According to a report published by Cushman & Wakefield's (C&W), 2014 was a massive year for the non-performing loan (NPL) market with the execution of a record €80.6bn of European commercial real estate and real estate owned transactions. Placing this figure into context, the C&W report stated that this "represented growth of 156% on the volume for 2013 with an increase of over €26bn on the totals for 2012 and 2013 combined". Looking ahead for 2015, C&W predicted that closed transaction volume in 2015 will be in the region of €60-70bn with Italy anticipated to be the next NPL "hot spot".

The rationale for the spotlight focussing on Italy stems from the ECB's announcement in October of their Asset Quality Review (AQR). The results revealed that four of the eight banks that were deemed to have capital shortfalls were Italian and €9.7bn of a €24.6bn capital void (as of 31 December 2014), was attributable to participating Italian banks. Given the hugely successful de-leveraging auction process undertaken by many banks in the UK, Ireland and most recently Spain, it is unsurprising that many market observers anticipate that Italy will follow suit with their own form of auction process. Although going down such a tried and tested route is no doubt a compelling option for the Italian banks, given the huge success of their CMBS 2.0 market I wonder whether the Italian banks may in fact have another string to their bow.

Driven by the fact that CMBS overcomes Italian domestic regulations requiring institutions purchasing syndicated loans to have a banking licence, we saw significant Italian CMBS 2.0 issuance over the previous couple of years. During the course of 2013 and 2014 there were a number of notable Italian deals (Gallerie 2013 srl; Deco 2014–Gondola; Moda 2014 Srl) and the deal flow did not abate in 2015 with the closing in January of Tibet CMBS Srl. and the pricing of Taurus 2015–1 IT.

In terms of future Italian deal flow, the continued low interest rate environment, the recent announcement of the ECB introducing large scale quantitative easing and investors' relentless search for yield, the likelihood is that the volume of primary CMBS issuance will increase further during the course of 2015.

For a long time I have held the view that CMBS is the perfect financing instrument to enable yield-driven private equity funds to maximise their returns on the acquisition of NPL's. Indeed the feasibility of such a funding tool was explored in a recent article that I had published in the fall edition of CRE Finance World (Europe's Future Power Couple – CMBS; A Financing Tool for NPL Portfolios). By employing similar technology to that discussed in the article i.e. transferring the loans to an issuing vehicle that funds such an acquisition through the issuance of CMBS notes to yield driven investors, the Italian banks will in effect have a mechanism to offload a significant volume of non-performing loans. Although compared to the current crop of CMBS 2.0 deals, the CMBS structures are likely to require some finessing to accommodate the fact that the loans were not originated for securitisation and are likely to be non-performing, such structuring is not insurmountable and is unlikely to stave off investor demand for notes.

Given that at the time Italy was one of a few countries where there had been significant CMBS issuance since the global financial crisis, but also a country where a number of its banks are under significant pressure to delever, we may therefore be at the perfect juncture in the market for CMBS 2.0 to be deployed as the answer to Italian bank deleveraging woes.

*This article was first published in Structured Finance in Brief, 4 February 2015*

**End**

# Europe's Future Power Couple - CMBS - A Financing Tool for NPL Portfolios

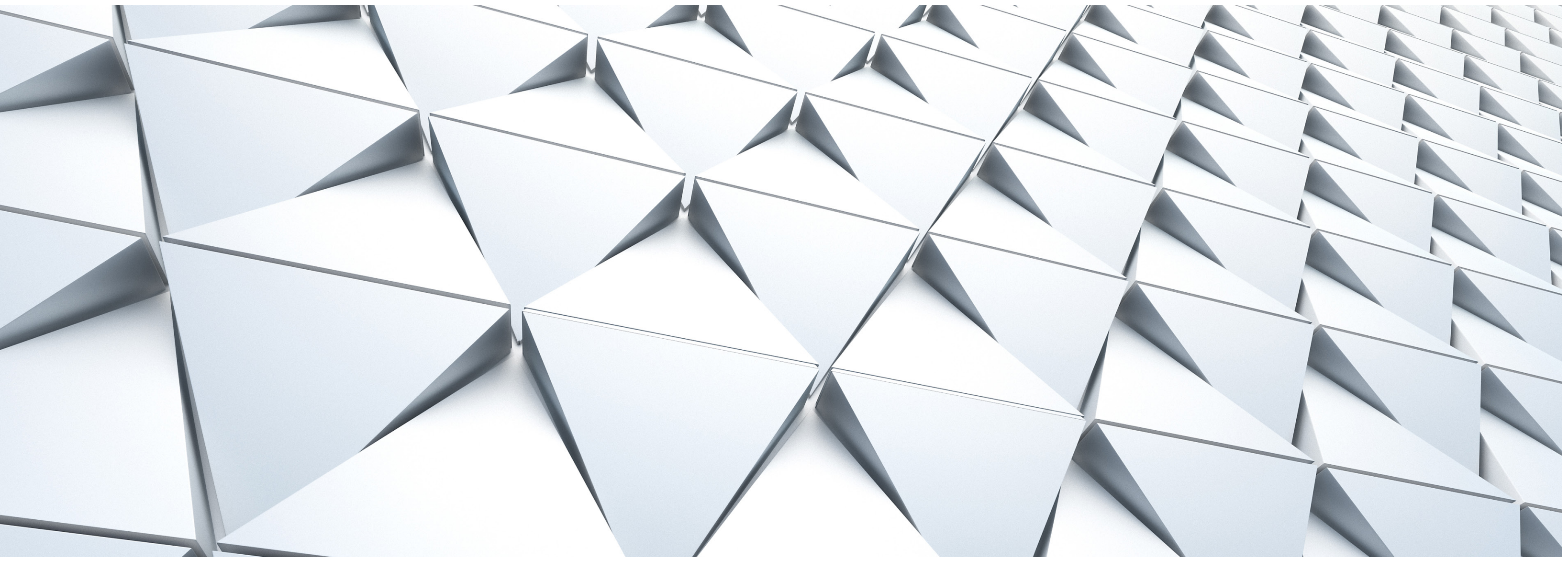
**Autumn 2014**

The European commercial real estate ("CRE") finance market currently exhibits the perfect conditions for the origination of a new CRE investment product that is structured using existing CMBS technology. CMBS 2.0 investors are currently demanding a greater volume of note issuance and of the paper that is issued they require higher yields and more variety in the CRE assets securing such paper. Meanwhile those investors in non-performing loans ("NPLs") clearly have an ever increasing appetite for NPL leverage. Against this backdrop, it is surprising that the European CRE finance market is still yet to harness the opportunity of using CMBS as an instrument for financing NPLs.

## The Re-emergence of European CMBS

Following the onset of the global financial crisis in 2007, the role of CMBS as a funding tool in the European market has been subject to intense scrutiny. Seven years on, several issuances later and following a prolonged upswing in financial market sentiment, there is every indication that CMBS has an integral role as a financing instrument for European CRE. The re-emergence of CMBS is evidenced by the year on year growth figures, with approximately €9 billion of notes issued in 2013 and forecasts for 2014 primary issuance will be in (if not surpassing) the €10-15 billion range.

The immaturity of the CMBS 2.0 market has manifested itself in a variety of ways, of which the most striking (despite the clear demand) is the limited volume of issuance. Of the paper that has been issued, it currently suffers from a notable lack of variety given that the underlying collateral is confined to German multifamily, Italian retail and a small handful of prime UK office and shopping centre properties.



## The European NPL Market

At the same time as we have witnessed the re-emergence of CMBS, the European CRE market has also seen the emergence of a significant NPL market that has been fuelled by deleveraging European banks selling off their non core assets (including a significant number of NPLs). The deleveraging process has ranged from single loan sales to mega pan European NPL portfolios secured by CRE across Europe. Whilst such sales have played an integral role in providing a mechanism through which the European Banks have been able to delever they have also provided a tremendous opportunity for value.

One of the notable features of the European CRE finance market compared to the market in the United States has been the lack of diversity in relation to CRE lending which is attributable to a smaller European CMBS market and fewer CRE loans held by insurance companies and other non-bank institutions. The lack of such diversity has manifested itself with a huge concentration of loans sat with the European banks (about 75%) which is a stark contrast to the United States (about 55%). Further, unlike in the United States, the European market is still in its relative infancy in the deleveraging process with many years yet to run. Given the high proportion of NPLs held by the banks coupled with the high likelihood that the European market is likely to stay active for a longer period compared to the United States, the European NPL market is proving to be an exciting prospect for the NPL investor (particularly investors from the United States).

To capitalise on the opportunities presented by NPL portfolios, over recent years Europe has seen a marked increase in the formation and expansion of funds. Although these funds have been deploying equity raised from all over the world to acquire these assets, to meet the level of returns demanded by their investors, it is usually necessary to leverage holdings in NPL portfolios. In the past eighteen months, Europe has therefore seen the formation of an active loan-on-loan lending market which is noted for the volume of such loans and also the range of such financing tickets given the size of some of the NPL portfolios that have traded.

Those lenders that have successfully landed these loan-on-loans will no doubt be richly rewarded, as most NPL portfolios are very granular with CRE located in a range of geographical locations, have a variety and number of tenants and include a range of different sponsors and asset managers. Furthermore, the investment fund that has been successful in acquiring an NPL portfolio ("NPL Sponsor") will continue to have significant skin in the game and therefore be strongly incentivised to ensure that any borrowing entity will continue to meet its payment obligations under the loan.

## CMBS and the NPL Portfolio — a Perfect Marriage?

In a market where investors in European CMBS are requiring greater volumes, yields and granularity of paper whilst at the same time Europe is also seeing the growth of an NPL financing market that is characterised by large loans secured by highly granular CRE, it is surprising that the European market has not seen a flurry of CMBS deals collateralised by NPL portfolios (an "NPL Bond"). On the face of it, the emergence of an NPL Bond would seem to be highly desirable: for the NPL Sponsor, it would increase the source of funds available to finance their NPL portfolios which in turn is likely to drive down the cost of leverage and for the CMBS investors, these types of deals would give them the volume, yield and variety of CMBS paper which their investment portfolios so require.

Those investors that have been successful in buying an NPL portfolio will frequently use a newly formed special purpose vehicle to acquire the loans ("NPL Lender"). Funding for the acquisition will typically take the form of the NPL Lender using 100% equity or a combination of debt and equity. In the event that any debt finance is used then the third party lender (typically a bank) will lend directly to the NPL Lender.

Although it would be desirable to issue an NPL Bond contempora-neously with the acquisition of an NPL portfolio, in practice this would be difficult to achieve. NPL portfolios are often sold as part of an auction process with the seller keen to offload the NPL portfolio swiftly following conclusion of such a process.

Given the time it would take to structure the NPL Bond and provide relevant disclosure, an NPL Bond would need to be issued following the acquisition of the NPL portfolio. An NPL Bond could therefore be structured in two ways:

- Agency Deal — the NPL Lender would enter into a loan with another special purpose vehicle which in turn would directly issue NPL Bonds into the market (see figure 1).
- True Sale — the financing bank would either securitise the acquisition loan or if pure equity has been used to acquire the NPL portfolio which is later refinanced, the bank would securitise the refinance loan (see figure 2).

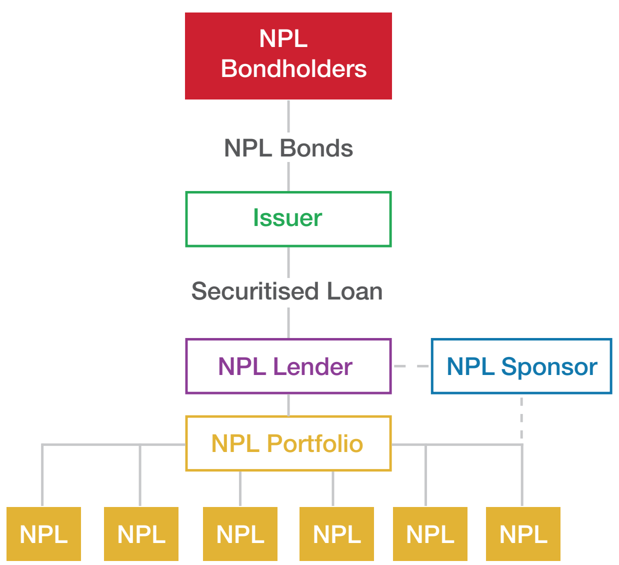



*Figure 1*

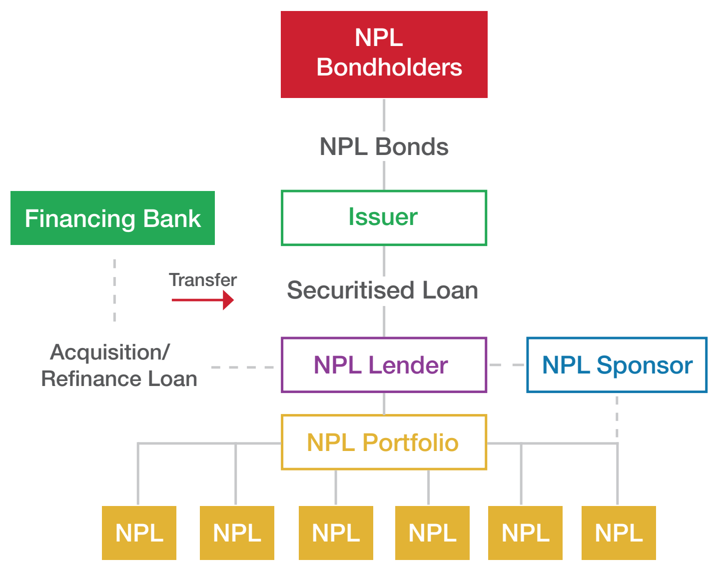



*Figure 2*

Although both structures are viable, the agency structure would clearly be the most desirable and cost efficient as unlike a true sale structure the financing bank would not be required to use any of its balance sheet to lend. Further, implementing this structure would mean that the arranging bank would not be required to retain 5% of the NPL Bonds in order to satisfy the 122a retention requirements under the European Commission's Capital Requirements Directive IV. It should however be noted that the NPL Sponsor or an affiliated entity as sponsor of the issuance would instead be required to retain a 5% interest of the NPL Bonds.

In both structures, amounts received under the NPL loans would be used to pay interest and principal on the NPL Bond. Security for these payment obligations would take the form of an assignment by way of security of the NPL Lender's entire security interest in each underlying NPL loan and a pledge granted over the shares of the NPL Lender. All security would be held by the bond security trustee for the benefit of the NPL bondholders.

Other than with respect to special servicing, the securitisation structure would resemble that of a standard CMBS 2.0 transaction. There are likely to be several agents (account bank, cash manager, paying agent) appointed to manage cash flows and pay amounts on the NPL Bonds. A bond trustee and security trustee would respectively have the role of representing the interests of the NPL bondholders and holding security granted by the issuing Europe's Future Power Couple — CMBS vehicle and the NPL Lender. Finally, credit enhancement would be achieved through various hedging arrangements and the provision of a liquidity facility.

With regard to the day to day administration of the underlying NPL loans, a servicer would be appointed who would also be responsible for providing reporting on such loans. However a special servicer is unlikely to be appointed to maximise recoveries on the underlying loans as this is a role that the NPL Sponsor (or one of its affiliates) is likely to expect to assume.

Immediately following the acquisition of an NPL portfolio, the NPL Sponsor would deploy their expertise in maximising the value of the NPL portfolio through either restructuring or enforcing the underlying loans. In both circumstances the NPL Sponsor would look to increase the value of the CRE securing such loans through either working with the borrower or obtaining direct control of the CRE itself through enforcement. Given that a special servicer's role is to maximise recoveries on underlying CRE loans following default, the NPL Sponsor's active role in the transaction and it's clear economic interest, would mean that in the case of an NPL Bond issuance there would not be a need to appoint a special servicer in relation to the underlying NPL loans — a clear deviation from the CMBS 2.0 standard.

In terms of enforcement rights following the occurrence of a bond event of default, the bond security trustee would be able to take control of the NPL portfolio by enforcing the pledge over the shares in the NPL Lender. Once such control has been obtained, the underlying loans could either be sold or action taken to maximise the recoveries on the underlying NPL loans for the benefit of the NPL bondholders.

## So What is Holding Things Up?

Despite the clear benefits of an NPL Bond and that there exists the capital markets technology to create such a product, to date there been no issuance of such a bond. This could be down to the current immaturity of the CMBS 2.0 market or there could be more fundamental issues that have caused industry participants to shy away from this product.

## Potential Investor Reservations

From the perspective of a potential NPL Bond investor, then they are likely to have concerns with nuances associated with the structure.

One of the major criticisms of European CMBS has been the complexity of many of the CMBS structures used prior to the onset of the financial crisis. These concerns have been addressed in new issuance, which has so far manifested itself with transactions featuring the securitisation of single loans backed by prime CRE with very straightforward securitisation and loan structures. In sharp contrast, an NPL Bond would be the complete antithesis of this with the underlying collateral comprising a portfolio of NPLs secured by secondary property.

The complexity with the NPL Bond product arises from the presence of multiple loans. Given these loans have not been originated or pooled together specifically for a securitisation, it is likely that many of their key payment terms (amortisation profile, payment dates, interest rate provisions and even currency) would vary and therefore have to be harmonised as part of any securitisation through the use of various hedging instruments. In addition the terms and conditions of the NPL Bonds are likely to feature complex redemption conditions as well as other structural features (non accruing interest (NAI) provisions and an available funds cap) to cater for the varying payment profiles of the underlying loans.

Although none of these issues are insurmountable and there are plenty of examples of this type of structuring in the 2004–2007 vintage of CMBS notes, nevertheless getting comfortable with such a structure would constitute a huge structural leap of faith for an investor in a market where the last true multi-loan CMBS issuance was in August 2007.

An investor may also have concerns with the representations relating to the collateral, given that due to the limited knowledge of an NPL Sponsor and the distressed nature of the underlying loans, the representations that the NPL Sponsor would be prepared to give are likely to be limited and at best highly qualified. Further, an investor would be wary of a significant prepayment risk with such a product caused by the underlying loan sponsors seeking to exit the loan as soon as feasible and the NPL Sponsor reluctant to Europe's Future Power Couple — CMBS restrict such action given that they would want to realise their profit at the earliest possible opportunity.

Finally, given that the NPL Sponsor or an affiliate would be taking on a special servicing type role from the outset of an issuance then an investor would need to get comfortable with the NPL Sponsor's ability to perform such a role. Clearly if the NPL Sponsor or its affiliate is a rated special servicer then this would be helpful in undertaking such analysis but this is unlikely to be always the case. From the NPL Sponsor's perspective the main issue with an NPL Bond structure is likely to relate to those issues that are inherent in raising debt via the capital markets.

Driven by their business needs or their desire to maximise value of the NPL portfolio, the NPL Sponsor may need to amend a material term of the securitised loan. In these circumstances the NPL Sponsor would not have the luxury of sitting down with a lender or club of lenders, but instead they would be at the mercy of the capital markets. To the extent that they require modifications, the NPL Sponsor would therefore have to embark on a consent solicitation process. Compared to agreeing terms bilaterally with a lender such a process could take a notable period of time, is potentially costly and unless they are able to "lock-up" individual bondholders there would be a level of uncertainty as to whether the requisite amount of bondholders would sanction such modifications. A possible solution to this, is allowing the bond issuer to retain a redemption option that could be exercised at anytime in order to collapse the structure and seize back control. Where it is likely that an NPL Sponsor's financing requirements are likely to change with respect to an NPL portfolio, then an NPL Bond may not be the best financing tool.

An NPL Bond issuance also imposes on the NPL Sponsor a variety of onerous disclosure obligations. As part of the issuance process, the NPL Sponsor would be required to disclose material facts such as key terms with respect to the acquisition of the NPL portfolio (including possibly its price), different loan strategies being considered with respect to individual loans and material facts about the operations of its business. Equally, given that the underlying credit is the underlying loans themselves, then the NPL Sponsor would be forced to agree terms with an underlying borrower to allow disclosure of material information relating to the loan including the CRE securing such a loan. Although such disclosure is viable, ultimately the NPL Sponsor has to decide whether it is comfortable or possible for such information to enter the public domain and to the extent that they cannot get comfortable, then an NPL Bond structure would be unlikely to work for them.

## Conclusion

An NPL Bond would appear to be the perfect marriage of CMBS as a financing tool providing much needed leverage to investors in NPL portfolios. However it is likely to be a while until we witness such a marriage given the structural seismic shift between an NPL Bond structure and those CMBS 2.0 structures that are currently in the market. As the CMBS market matures and structures undoubtedly become more complex, and assuming that it can be demonstrated to an NPL Sponsor that an NPL Bond provides a cheaper form of finance compared to a traditional bank loan, then it is likely to be simply a matter of time until the European market witnesses its first ever NPL Bond issuance.

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**End**

# Non-performing loans

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**The World Financial** *Iain Balkwill, Partner*

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