SPECIAL REPORT

GLOBAL NON-PERFORMING LOANS

The sale of non-performing loans improves general economic efficiency, stabilising markets and encouraging inward investment. Banks around the world are finding ways to deal with the NPL problem more effectively. China and Germany are the hot spots at the moment, where abundant opportunities have caught the eye of the investment community – both domestic and internationally.

Structuring and negotiating the sale of an NPL portfolio requires a thorough understanding of financial and regulatory limitations – particularly in emerging markets where there are calls for legal changes to assist the transfer of assets. At the heart of a successful sale is the undertaking of thorough due diligence to analyse all available information and assess the risks involved. Once this is done, it is down to advisers to broker a deal between buyer and seller – with all the nuances of negotiations this entails.

In a rapidly maturing market, it is crucial for advisers to keep up-to-date with the issues. This special report brings together top practitioners to gain an insight into the workings of today's NPL arena.

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GLOBAL NON-PERFORMING LOANS ROUNDTABLE

GUEST MODERATOR

Jack Rodman
Partner, Managing Director, Ernst & Young
Phone: (86) 10 6524 6688
Email: jack.rodman@cn.ey.com
www.ey.com

Mr. Rodman presently lives in Beijing, China, where he is focused on helping Chinese Banks resolve their NPL problems through international auctions or structured joint ventures with foreign investors. To-date, Mr. Rodman has served as Financial Advisor to the People's Bank of China and three of the four State Owned Commercial Banks while closing the two largest international NPL auctions in China on behalf of China Huarong Asset Management Corporation.

THE PANELLISTS

Michael P. Harris
Partner, PricewaterhouseCoopers
Phone: (86) 10 6505 4890
Email: michael.p.harris@cn.pwc.com
www.pwcglobal.com

Jerome W. Jakubik
International Partner, Baker & McKenzie
Phone: +1 (312) 861 2886
Email: jerome.w.jakubik@bakernet.com
www.bakernet.com

Vincenzo Paparo
Partner, Proskauer Rose LLP
Phone: +1 (212) 969 3125
Email: vpaparo@proskauer.com
www.proskauer.com

Gifford S. West
Managing Director, DebtX
Phone: +1 (617) 531 3436
Email: gwest@debtx.com
www.debtx.com

GLOBAL ISSUES

Rodman: How can the sale of NPLs benefit the domestic economies in which they are active?

West: Domestic economies benefit from NPL sales because they increase the confidence of investors in the health of the banking institutions. This translates into lower funding rates and greater access to credit. NPLs that have been sold tend to be resolved more quickly, allowing companies and industries to accelerate their recovery versus a prolonged NPL crisis.

Jakubik: The domestic economies of the selling banks' home countries are benefited by NPL sales in that more financial resources are then available from the selling bank for new loan activity, rather than the collection of NPLs. In addition, the obligors of NPLs are often able to settle these debts for less than the face amount thereof (which often is a constraint on settlement with the selling banks) and thus bring their indebtedness more in alignment with their financial resources.

Paparo: Quick resolution of NPLs permits the financial institution to return to a lending mode sooner, minimising losses, fostering new lending and thereby fuelling economic growth.

Rodman: What methods can banks actively implement to reduce their NPL exposures in the future?

Harris: Banks should consistently apply loan application and credit approval procedures and eliminate the influence of third parties like local government agencies. Moreover, banks can update and integrate their various database systems into one useful tool, providing management with state of the art systems and up to the minute status of loan book, concentration to borrowers or industries, and so on.

Jakubik: Prudent lending and loan evaluation procedures must be strictly enforced. As soon as a loan is determined to be of uncertain collectibility, administration of the loan needs to be transferred to specialists in the bank trained in loan collection procedures, rather than left in the hands of the originating bank officers.

Paparo: Well-structured transactions with strong underlying documentation that clearly and correctly delineate the lenders' legal rights, will go a long way towards avoiding NPLs. When problems invariably arise, the liquidity of the secondary debt market will be easier for the financial institution to access with properly documented laws, and thereby garner palatable prices, which in turn will help reduce NPLs to acceptable levels.

West: NPL's are inevitable within a profit-seeking bank. What banks should be seeking to avoid is NPL 'surprises' where years of non-performance are recognised in a single calendar period. The most effective means of avoiding this scenario is through effective fair ▸▸

market valuation of the bank's loans on at least a quarterly basis. The most effective means of assessing fair market value is to be constantly selling a small volume of NPL and distressed credits.

Rodman: What are the key issues for investors when targeting NPL opportunities?

Paparo: Investors look at asset quality, pricing and likely rate of return on the collateral. In addition, the quality of the underlying loan documentation and the attendant legal rights and costs associated with enforcing the rights under the loan documents in a particular foreign jurisdiction are critical factors when determining risk.

Harris: The issues and goals of investors may vary depending on the jurisdiction or location of NPLs. As a rule, investors will focus on the existing or proposed legal framework for bankruptcy, liquidation, reorganisation and composition, as well as the availability of extensive third-party information on market and sub-market conditions by geography and by collateral type.

West: Access to deal flow is the most significant issue for all but the very largest NPL investors. In newer NPL markets (such as China and Germany), sellers historically have not been able to manage the logistics associated with multiple bidders. Consequently, they have typically chosen a strategy to sell large portfolios to the largest funds. These funds, in turn, resell the asset to smaller funds, reducing returns to all but the largest players.

Jakubik: In order to perform a critical evaluation of the opportunity, investors are looking for transparency in the legal risks associated with the loan collection activity in the subject country. The legal issues involved in the purchasing and servicing of the NPL portfolio should be reviewed by relevant legal counsel and the legal risks identified. Before proceeding, it should be clear that any legal risks have been resolved to permit purchases and servicing activity.

Rodman: What are some of the structural and procedural considerations that advisers take into account when acting on behalf of banks to dispose of an NPL portfolio?

Jakubik: Advisers must review and evaluate the NPL assets involved in the portfolio and determine whether such NPLs will be sold in combined or separate sales or tranches, and done so in auctions or private sales. Second, advisers need to determine whether it is best to sell the most-collectible or most-secure assets first or to combine desirable assets with less desirable. Often, there is a reluctance in the selling banks to perform a great deal of 'due diligence' at this stage, although this is critical if the bank is to be able to evaluate properly the bid prices received, as well as enabling it to establish a reserve or minimum price for the portfolio. Finally, a decision needs to be made as to whether a definitive form of sale and purchase agreement and terms will be proposed, and the minimum conditions to be set out in such form.

West: The role of the advisor is to ensure that the bank receives the highest possible proceeds while minimising the risks associated with litigation, execution risk, and brand damage. Proceeds are maximised by structuring the sale to ensure that a critical mass of bidders will engage in the due diligence process and submit conforming bids. This is achieved through effective pooling, targeted marketing, effective management of the due diligence process, and a clearly fair and transparent bidding process.

Litigation is minimised by ensuring that the sale is conducted within the framework of clearly articulated rules, that the due diligence process is comprehensive and consistent across all participants, and that asset sale contracts are drafted to address local issues. An effective due diligence process must ensure that as much information as possible is made available to potential buyers, that all buyers have access to the same information, and that this access can be demonstrated.

Paparo: The legal advisers to the financial institution will seek to ensure that all of the applicable loan documentation is assembled, that confidential communications are preserved and the files generally reflect the proper legal status of the loans being marketed to investors.

Harris: As a final note, it is prudent to establish a realistic timeframe for closing the deal, and assess its impact on the other goals of the selling entity, such as year-end closing of financial statements for accounting purposes.

Rodman: Are there often major differences between the due diligence performed by buyers and sellers at the time of sale, and the actual performance of the assets over time?

West: From the seller's perspective, the critical aspect of the due diligence process is that it allows the buyer full access to all relevant information. If, after the fact, the buyer can demonstrate that the due diligence process did not represent a full disclosure, then the seller has effectively given the buyer a free option to 'put' the portfolio back at a later date. It is therefore critical that the due diligence process is organised in a professional manner. All bidders must be given equal access, all information must be made available and access and availability should be demonstrated after the fact.

It should be noted that sellers pay for any 'guesses' that the buyer needs to make. Professional buyers, when confronted by a gap in due diligence material, will assume the worst scenario and price accordingly.

Paparo: The seller has lived with the NPL portfolio for a much longer period of time than the investor, who must rely upon the quality of the due diligence materials provided by the seller prior to making an offer. The seller will often see greater value over the long term where in contrast an investor will seek to hedge its risk by discounting certain positive factors in light of its limited exposure to the NPLs. Many experienced investors have developed a fairly sophisticated matrix for evaluating NPL portfolios and their likely return.

Harris: As a general statement, the due diligence process performed by sellers and buyers is not likely to be materially different. Since the due diligence performed by sellers supports a range of expectations used to price acquisitions during the bid process, there can never be an assurance that facts and circumstances will materialise as originally forecast at the time of asset resolution. As a general statement, the due diligence process can and does provide a 'reasonable' assessment of possible results. Our experience would suggest that sophisticated investors do not use a guesswork approach but consistently try to apply a reasonable assessment approach based on information available at the time of the analysis.

Jakubik: Unfortunately, sellers often do not perform adequate due diligence, and also may not permit adequate due diligence by buyers. The result is that price expectations of buyers and sellers can vary substantially, adversely affecting the completion of an agreed sale of the NPLs. In a properly organised sale, particularly where the assets ▸▸

and risks are properly described in the offering memorandum and loan files are available for inspection, the due diligence process can provide to sellers better financial bids. However, because of the nature of NPL assets, there always will be a certain amount of guesswork and one of the more significant issues will be the amount in the bid price for such contingencies. Due diligence reduces the need for arbitrary contingent amounts.

Rodman: What are some of the difficulties that arise when valuing an international NPL portfolio comprised of diverse collateral?

Harris: Some key difficulties include estimating the timing of the ultimate asset resolution, estimating the amount of the proceeds that will ultimately inure to the benefit of the investor, and reconciling the value gap expectations between buyer and seller triggered by differing assumptions as to discount rates and yields to be applied.

Jakubik: It is often difficult to determine the extent that collection efforts may have preceded the sale and the action needed to be taken to preserve rights against obligors. Real estate collateral is the most critical collateral in any portfolio, and it is often difficult to determine if the real estate is properly subject to an enforceable mortgage and will be available to the NPL portfolio purchaser on foreclosure of the related loans. In many jurisdictions, rights in the real estate may be unclear or subject to governmental discretion or mortgage foreclosure activity may be expensive and uncertain.

West: Given an international NPL portfolio with diverse collateral, the 'all-or-none' price may significantly represent a serious discount versus the value of the component parts. The seller and his or her adviser need to assess the benefits of selling the portfolio as a single pool versus segmenting the portfolio into more homogenous sub-components. In my experience, sellers almost always raise net-proceeds through stratification of NPL portfolios into relatively homogeneous pools.

Paparo: The ability to establish a worst case liquidation scenario is another problem. The investor must familiarise itself with the regional and local laws which might impact the value of the collateral and the ability to seek judicial relief when it is contemplating a timely recovery from the liquidation of the collateral.

Rodman: What representations and warranties on the description and nature of the assets or security should be required of the seller?

Jakubik: Often sellers are unable or unwilling to make such representations and warranties because they do not have and do not want to acquire adequate information on which to base them. If extensive representations and warranties are made without the necessary due diligence basis, there will likely be adverse consequences to the seller when buyers prove the representations and warranties arer incorrect and seek remedies. This then leads to the 'put back' or mandatory repurchase of the misrepresented loans to the seller and the adjustment or refund of the related purchase price for the misrepresented loans – a situation neither seller nor buyer really wants.

Harris: One of the greatest areas of contention and dispute during the drafting and commentary timeframes is associated with the Sale & Purchase Agreement. Early on, many buyers might expect or demand representations and warranties more consistent with their expectations from doing 'deals' in developed countries. In developing countries, many sellers of NPLs in the emerging market are more inclined to limit their representations and warranties language and try to sell the loans on an 'as is' basis. The reasons for this may include the ongoing development of bankruptcy legal statutes, contractual law provisions, title, and loan registration.

Paparo: At a minimum, an investor should receive representations and warranties which state that the collateral for the loan is described accurately and fully by the loan documents. However, expecting a financial institution to rep and warrant the priority of the lien position or the nature of the collateral will be difficult to obtain and somewhat unrealistic to expect. Sellers, for practical and legal reasons, often try to minimise representations and warranties. This tendency is reflected in the debt trading rules promulgated by the LSTA and LMA.

West: Ultimately, the representations and warranties provided by the seller reflect the seller's leverage over the potential buyers and the effectiveness of the seller's negotiation skills. Properly executed, the auction structure should maximise the seller's negotiation position and consequently minimise the required representations and warranties provided. In my experience, sellers are never properly compensated for representations and warranties beyond 'we own it and we can sell it.'

Rodman: How can the gap between what investors are willing to pay and what banks can afford to accept be bridged?

Paparo: Financial institutions should value NPL portfolios based upon what the market is willing to pay for those assets versus what the financial institutions believe they can recover if they workout the loans. Investors on the other hand will need to have greater access to updated information regarding the credit, confidence in the enforceability of the loan documents and their ability to obtain access to the underlying collateral for liquidation purposes.

West: The gap can be bridged through a variety of vehicles that share risk between buyer and seller. Examples are joint ventures, participations, and put backs. The challenge for the seller is to ensure that a partial disposal of its NPL position achieves its strategic objectives and that the associated options have been correctly priced.

Harris: Advisers typically use a structured finance approach, subject to limitations imposed by local legal provisions, and apply the accounting provisions as to sale versus contingent sale.

Jakubik: If an efficient market can be created so that both buyer and seller are operating with the same basic facts and understanding, the payment 'gap' should be reduced.

Rodman: In what ways can financial, accounting and legal deal advisers work together to maximise results for their clients?

Harris: All vested parties need to participate in the planning and assessment phases of the suggested business plan. Too often, outside advisers are brought into the transaction only after the selling institution has already decided on an approach and appears reluctant to alter the initially agreed-upon plan.

West: An experienced Loan Sale Advisor is critical to co-ordinate the activities of the accounting and legal support teams, but most importantly to ensure that a critical mass of buyers submits conforming bids. Poor marketing of a portfolio wastes the investment of the proper preparation of due diligence material and legal documents.

Paparo: The various advisers must communicate to each other their methodology and conclusions to ensure that the pricing recommendation does not fail to consider all material factors which can affect the ultimate recovery for the investor or the financial institution.

Jakubik: Preparation is the key. The more effort that is spent organising a portfolio and the terms of sale, based on the precedents that now are available, the greater the likelihood of a successful sale. Each deal adviser should be given a clear role in this process and there should be continuing consultation among them. Often, advisers are engaged separately and do not coordinate or communicate sufficiently.

EUROPEAN MARKET

Rodman: Germany is being touted as the European centre of interest for NPL investors. What are some of the notable aspects peculiar to the German market, which buyers and sellers will have to keep in mind?

Paparo: Current estimates of NPLs in Germany are approximately €300bn, however, there are significant regulatory and accounting considerations, which are making NPL portfolio sales difficult to consummate. One of the significant issues is the amount that investors are willing to pay versus the value ascribed by the German banks to their NPL portfolios. Due to the favourable creditor laws in Germany many German financial institutions have, and rightly so, carried high valuations for their NPL portfolios. In addition, German NPLs tend to be underperforming loans rather than distressed or charged-off loans where the likelihood of the loss is significantly higher. Finally, Germany has a strong and growing economy. Investors who do not consider these factors will likely not be prepared to pay higher prices for NPLs which they mistakenly believe might negatively impact their rate of return.

Jakubik: There is a long tradition of 'pfandbrief' transactions in Germany in which special purpose mortgage lenders securitise assets. This will affect mortgage related portfolios. Other types of loans may have inflexible security arrangements that may not be able to be transferred to investors without cost or tax concerns.

West: While the German NPL market has many challenges, none are insurmountable. German banking and data protection laws must be addressed to protect both buyer and seller. Both can be dealt with through effective processes and deal management.

Rodman: Are there any factors that may interrupt successful NPL deals taking place, and German banks moving the estimated €300bn from the books?

West: For truly non-performing loans, there are no obstacles to the successful creation of a liquid NPL market in Germany: precedents have been set, buyers are eager, sellers exist, and third party servicers are coming on-line.

Paparo: Given the high book value of the respective NPL portfolios of German financial institutions, there is a fundamental disconnect between their expected recoveries versus the amount an investor would typically be prepared to pay to purchase an NPL portfolio.

Harris: In earlier attempts at disposing of NPLs, some European financial institutions tended to use their own divisions to coordinate efforts between buyers and sellers. This often creates a perceived conflict of interest that may be counter-productive to achieving an environment where the highest and best results are achieved. Early on, in a couple of European markets, prospective investors were also disappointed when announced sellers did not follow through with the ultimate sale of assets. Using third party, independent advisers, coupled with creating a perception that the financial institution is committed to the sale process, is key in moving forward with a successful implementation program. This is true regardless of the jurisdiction.

Rodman: What impact will Basel II have on banks' attitude towards NPLs and what measures are we seeing banks take in preparation for the regulation?

Jakubik: In the short term, the Basel revisions are inhibiting the willingness of banks to package and sell NPLs until such regulation is finally in place. Once it is in place, banks may have more incentive to dispose of such assets since they will be required to evaluate such assets in a more realistic manner.

West: Basel II will increase the consistency with which banks address NPLs on an international basis. This in turn will improve the availability of tools, markets, and expertise for managing NPL risk.

Paparo: Basel II will drive many financial institutions to reevaluate their current method of capital risk management. In addition, financial institutions planning to adhere to the Basel II accord will sell NPLs in order to meet the capital requirements and to minimise any future charges to the financial institution's capital as a result of Basel II. This process should result in an increase in NPLs availability in the secondary debt market.

ASIAN MARKET

Rodman: Although there has been some fanfare regarding foreign investors entering the NPL arena in China, only a handful of transactions actually closed. Why is this?

Paparo: There are a number of significant reasons, not the least of which is that the international investment community has been awaiting the adoption of bankruptcy law reforms which should result in a more 'creditor-friendly' and transparent bankruptcy process and therefore a more attractive environment for NPL purchases and sales.

Jakubik: There have been difficulties in obtaining regulatory approvals and in the correct evaluations of portfolios. Difficulties conducting due diligence and related issues have adversely affected the completion of more sales. Also, the number of willing investors continues to be relatively small, due principally to the perceived risks.

Harris: Exorbitant timeframes are required to obtain requisite approvals, and there is a lack of steady flow of NPL inventory to the investor community. Multiple asset-management companies (AMCs) are competing with each other for limited capital and investment. When deals do arise, the method of original transfer of NPLs to AMCs and the basis (or purchase price) of the assets, as well as the financing ▸▸

program utilised, is often called into question.

Bankruptcy laws also need to evolve further. In their current state they place a limit on possible exit strategies. More detailed codification of tax provisions impacting NPLs and the entities that acquire NPLs are needed. In addition, foreign investors and private domestic investors can be held back by the existing land registration status on many assets and the possible costs associated with conversion of land-use rights.

Rodman: It has been said that the auction process in China is biased towards domestic Chinese, with branches of AMCs and banks preferring to maintain control of the assets and dispose of them to domestic investors. What is your view on this debate, and how will it influence future foreign investment into NPLs?

Harris: The AMCs have been in existence for almost six years. Recent additional transfers to AMCs and more recent guidelines directed at the AMCs to resolve older portfolios by the end of 2006 suggest – regardless of past practices by AMC personnel – pending deadlines should theoretically not allow a continuation of the 'maintaining control' approach to asset resolution. This is triggered primarily from a need to sell large pools of NPLs in bulk sales in order to achieve the desired disposition results. To date, sales and disposition results would suggest AMCs have generally relied on more of the individual asset resolution approach with domestic investors.

Jakubik: There will continue to be advantages to domestic investors that are knowledgeable and experienced in the domestic loan collection process, and this will not change substantially in the near term, which favours domestic investors. However, more joint venture arrangements are expected as foreign capital and international experience are joined with domestic knowledge and experience. Such joint ventures should provide equal opportunity for such transactions.

Rodman: Will the current legal requirements in China – where banks are barred from selling NPLs at anything less than book value – force sellers to pursue joint ventures with foreign investment banks? If so, will they get a fair deal?

Jakubik: Joint ventures will continue to provide many advantages. In such transactions, the problem will not be obtaining a fair deal. Raither, the number of foreign entities willing to negotiate such transactions is limited, which adversely affects the bargaining ability of sellers.

Harris: There is an exception in the existing PRC provisions for sale of 'settled' assets at a lower price. While allowing commercial banks to sell directly to buyers would probably prove more attractive to investors and reduce the role of the AMCs as 'intermediaries', most market watchers do not anticipate changes to the existing provisions until the AMCs have worked through and disposed of their existing portfolios. Korea provides a specific example of the increase in market activity, market awareness and pricing that occurred when commercial banks began selling directly to investors (rather than to KAMCO). However, allowing PRC commercial banks to compete directly with AMCs could have a very detrimental impact on the interest level of investors towards many of the AMC-owned assets.

Rodman: In what ways – and with what success – has the Chinese government attempted to tackle the country's NPL problem?

Harris: Really, it's too soon to tell. Arguably, Chinese commercial banks have or will have tackled much of their NPL problems by shifting the burden to the state-owned AMCs. At the commercial bank level, progress is being made. Whether this momentum has carried through to all nationally-owned entities and positively impacts the sovereign state, the arguments are too great and the differences of opinion too deep to suggest the NPL resolution has been a success at the national level. China still has an opportunity to ultimately claim success. However, it cannot afford to lose any more time.

Jakubik: The Chinese government has effected NPL sales by the use of private transactions, special purpose AMCs owned by the four major state owned banks, and the more well-known auction transactions that have included joint ventures. Securitisation transactions are at their early stages but have expanded the investor possibilities. There has been only limited success to date, principally because of difficulties in governmental approvals. This is being addressed and corrected by putting more discretion in the selling entities to complete NPL transactions. Unfortunately, much of the initial enthusiasm for such transactions, and many of the initial participants, no longer reside in Asia to complete these transactions. Seller and investors must develop an institutional approach so that such transactions can be continuously carried on.

Paparo: Chinese banks continue to have significant NPLs notwithstanding the AMCs, proposed new bankruptcy laws and efforts to facilitate sales of NPLs to international investors. It remains to be seen how effective these reforms will be in reducing NPLs in the long term if basic loan underwriting and documentation standards are not strengthened by the financial services industry.

Rodman: Looking ahead for the next 6-12 months, how do you see the deal pipeline for distressed assets shaping up around the globe?

Jakubik: There will continue to be NPL transactions in Asia, Eastern Europe and Russia. Possible NPL transactions also may arise in Latin America, particularly, Argentina if that country resolves its external debt. NPL transactions in Africa and the Near East are possible but unlikely. However, each of those regions should present interesting opportunities for NPL transactions, since very few have been done to date.

Paparo: The situation in Europe is somewhat better with some attractive investment opportunities in Germany and, in particular, senior bank debt and mezzanine loans. The market in the US will remain weak through 2005 given the strength of the economy.

West: The major markets to watch are the European markets, particularly Germany. These markets have seen critical developments in 2004 that make the development of further liquidity likely. Of greatest interest has been the execution of a number of benchmark transactions as well as the emergence of multiple third party servicers.

Harris: Pipeline prospects certainly depend on local conditions. However, due to a variety of reasons impacting local lending institutions and economies, the global pipeline has all of the makings of being extremely fruitful. There are likely to be further developments in China, Germany, India and particular Latin American countries. ■

GERMAN COURTS RULE IN FAVOUR OF TRANSFER OF NPL PORTFOLIOS

BY PHILIPP VON HOLST

The German NPL market.
Over the last two years, Germany's large market for the purchase and sale of portfolios of non-performing loans (NPLs) has become the focus of US investors and specialist private equity firms. Today, Germany is believed to be Europe's largest distressed debt market by far with an estimated €200bn – €300bn of bad loans. While there is still a large gap between the amount investors are willing to pay for a NPL portfolio and the value ascribed by the originating German bank to such portfolio in its asset books, by now, most of the banks have made provisions for the sale of their NPL portfolios and the last two years have seen significant and increasing activity by a variety of international investment banks and specialist private equity firms. In the summer of 2003, US private equity fund Lone Star helped to establish the market in Germany with the purchase of €225m of bad loans from the insolvent Gontard & MetallBank AG (G&M), a defunct regional lender. In November 2003, Goldman Sachs acquired all of BW Bank's non-performing loans to real estate company WCM. The same month, Munich-based Hypo Real Estate AG (HRE) completed a €419m sale of a NPL portfolio to a joint venture between J.P. Morgan Chase and Lone Star. In 2004, NPL portfolios with a face value of at least €6.5bn and single loans with a face value of €4bn changed hands. In addition, there were more than €10bn of property deals, including the sale in September 2004 of a €3.6bn portfolio by HRE to Lone Star. In October 2004, the institutional restructuring unit (IRU) of Dresdner Bank announced the sale of €1.2bn of bad debts. Investors believe that Germany's distressed debt market could grow by 50 percent this year. The market, so far, is dominated by US investors like Morgan Stanley, Goldman Sachs and specialist private equity firms like Fortress, Cerberus and, in particular, Lone Star.

Recent court decisions and legal implications
In the past, German banking secrecy obligations and the German Data Protection Act have been viewed as obstacles to the dissemination of information on NPL portfolios to potential purchasers. While the German financial regulatory authority (BaFin) has generally not opposed such disclosure provided that the recipients undertake to keep the information confidential, a couple of recent decisions by German courts have been closely watched by investors.

In a preliminary injunction proceeding in May 2004, the Higher Regional Court of Frankfurt (*Oberlandesgericht Frankfurt*) issued a preliminary ruling regarding the non-transferability of loans which happened to be part of the NPL portfolio which Lone Star acquired from Gontard & MetallBank in summer 2003. The court granted a preliminary injunction against the foreclosure on collateral securing the loans. The court found that, due to the existing banking secrecy obligations, the bank and the borrower were deemed to have implicitly agreed on the non-transferability of the loan and, thus, neither the loan nor the corresponding collateral were validly transferred.

This ruling caused substantial disturbance among the financial investors in the German NPL and securitisation market. Since then, many other borrowers in similar cases have claimed the invalidity of the transfer of their loans.

In December 2004, the Regional Court Frankfurt (*Landgericht Frankfurt)* which is competent for the actual proceeding on the merits ruled that the transfer of the loans in question from Gontard & MetallBank to Lone Star was valid. In November 2004, a ruling of the Regional Court Koblenz (*Landgericht Koblenz*) came to the same result based on nearly identical facts.

In line with the prevailing opinion in the literature, the Regional Court Frankfurt held that neither banking secrecy obligations nor other data protection obligations of the originating bank would, as such, lead to an invalidity of the transfer of the loans. In its reasoning, the court acknowledged that there is case law rendering invalid the transfer of claims of doctors and lawyers against their patients or clients if the transfer occurs without the consent of the patient or client, based on the rationale that the disclosure of personal data in those cases violates statutory prohibitions and is a criminal offence. The court then concludes that the rationale of such case law could not be applied to a violation of a banker's duty to secrecy. A banker's duty to secrecy is not part of German statutory law but rather based on contract as part of customary German banking terms contained in the standard terms and conditions; in addition, the violation of the banker's duty to secrecy is not a criminal offence. Accordingly, the court held that borrowers cannot claim the invalidity of the transfer of their loans but may only resort to potential damage claims against the originating bank based upon a violation of the banking secrecy as part of the bank's contractual fiduciary duties. Conversely, violations of the obligations under the Data Protection Act discussed below may lead to penalties.

This recent rulings of the Regional Courts in Koblenz and Frankfurt (which may be appealed) confirm the leading opinion in the legal literature and certainly help to address doubts which have arisen in relation to the transferability of NPLs in Germany. Even though both rulings were issued with respect to specific circumstances in an individual case, the requirements for an originating bank which wants to transfer its NPL portfolio for handling personal data of the borrowers have become more certain.

In order to determine which level of data protection has to be observed in a NLP transaction, the bank will have to differentiate between loans that are in default on the one side and loans that are not actually distressed but just part of the portfolio because the originating bank no longer wants to serve a certain type of client or industry. It also makes a difference whether the loan in question was granted to a private individual as consumer loan, or to a private individual as a commercial transaction or to a corporate borrower. While the banking secrecy obligations apply to all three types of loans, the Data Protection Act applies only to private consumer loans.

Principally, confidential and personal data may be provided to the buyer of a NPL portfolio only with the consent of the borrower. However, in line with the prevailing opinion in the legal literature which applies a balancing of interests test, the Frankfurt Regional Court has now confirmed that confidential and personal data may be disclosed to the buyer of a loan portfolio if the interest of the bank to sell the portfolio prevails over the interest of the borrower in the confidentiality of his or her personal data. This is held to be the case if the loan is in payment default when the interest of the bank to realise its claim against the borrower by way of sale prevails.

But even if the loans in the NPL portfolio were not in default and the interests of the borrower prevailed, the transfer of such loans remains a valid legal transaction. In its recent ruling of December 2004, the Regional Court Frankfurt has confirmed that the obligations alone under the banking secrecy laws and under the Data Protection Act do not lead to an invalidity of the transfer of loans which are not in default. Violations of the banking secrecy are only viewed as a violation of a

contractual fiduciary duty and might then lead to potential damage claims of the customers. A general possibility to avoid violations of banking secrecy and data protection laws would, of course, be that the originating bank continues to service the NPL portfolio. Thus, no personal data would have to be transferred to the investor. However, in practice the investor will often want to take over the servicing as well. In this case, the following structures have been used in German NPL transactions to comply with its obligations under the banking secrecy laws and the Data Protection Act, in accordance with the prevailing legal literature and the practice of the BaFin: For the due diligence of the purchaser, data will be provided only on an anonymous basis. The full personal data necessary for the legal transfer (*right in rem*) of the NPL portfolio will be provided to a data trustee (usually someone sworn to professional secrecy like auditors, notaries or lawyers, or even other financial institutions). Again, such a data trustee is not believed to be necessary if the borrower itself is in default.

With respect to securitisations, personal data are provided to a data trustee on an anonymous basis, but in case of a borrower default will be provided in full to the party acting as administrator of the loans.

Alternative structure: share deal

In the early deals, the NPL portfolios were mostly transferred directly to the investor by way of an asset deal. Based on the uncertainties partially caused by the alleged violations of the banking secrecy and data protection obligations in connection with a direct transfer of the portfolio, other alternative structures for the acquisition of NPL portfolios were developed. One of them is a transfer of the NPL portfolio by way of a drop-down (*Ausgliederung*). This means that the originating bank, in a first step, contributes the loan agreements to a wholly-owned subsidiary and, in a second step, sells the shares of the subsidiary to the NPL investor. This acquisition structure was used for the first time in the sale of the NPL portfolios by HRE in September 2004 and by Dresdner Bank in October 2004. Even though also in this structure banking secrecy and data protection laws have to be observed, the drop-down/share deal structure has been deemed to be more robust as there were never any doubts that the loan agreements may be dropped down without the consent of the borrowers.

Servicing NPL portfolios.

Most of the investors in the German NPL market with substantial NPL portfolios, are also looking at servicing those portfolios themselves. Although collecting amounts due under loans and related administration work is an unregulated activity under German law if no accounts are administered in Germany and, as such, may be carried out by anyone, the BaFin has indicated that the process of working out a loan (enforcing collateral, re-negotiating loan terms and payments, etc.) requires the involvement of an entity which is licensed as a German credit institution or is authorised to carry out similar activities in another EU member state (European passport).

As many investors will not have such a license, they need to cooperate with a bank that is sufficiently authorised to work out loans. Rather than partnering with another bank, some of the specialist private equity funds are now actually looking into obtaining or even buying their own banking license. Lone Star, which claims to have acquired two-thirds of all German NPLs sold by banks last year, is currently negotiating to buy tiny Mitteleuropäische Handelsbank from NordLB, the Hannover-based regional bank, in order to inherit a banking license. Besides that undertaking, the group is also understood to be considering buying a banking institution much bigger with a balance sheet of about €10bn. In addition, as Lone Star, the US investment group Fortress is also said to be looking to obtain a banking license in Germany, either by applying for one or through acquiring a shareholding in an existing institution.

Conclusion

Germany continues to present an attractive environment for German banks to sell potentially risky loan portfolios and for international to investors benefit from their experience in managing and working-out of NPL portfolios. The recent transactions of HRE and Dresdner show alternatives of how NPL portfolios can be structured as share deals (with a prior drop-down) in order to address legal concerns, including with respect to banking secrecy. On the other hand, the recent decisions by the Frankfurt Regional Court and the Koblenz Regional Court confirm that the direct transfer of NPL portfolios by way of an asset deal is not prevented by banking secrecy laws and, thus, may remain a viable option. The decisions being subject to appeal, it remains to be seen if the creditor-friendly approach will stand up against challenge in the appellate stage.

Philipp von Holst is an international counsel at Debevoise & Plimpton LLP.
He can be contacted on +49 69 2097 5000
or by email: pvonholst@debevoise.com

CHINA' S NPL PROBLEM: A LEGAL ANALYSIS

BY HOWARD CHAO AND YI ZHANG

By the numbers, China's record for sales of NPLs to international investors has been less than impressive. Over the last four years, only US$6bn or so in face value has been sold to foreign purchasers, accounting for probably less than one percent of all the NPLs in China. This is in sharp contrast to the billions of dollars of NPLs that China has otherwise disposed of during this same period. One major reason for this poor performance lies in a legal regime that is clearly inadequate to deal with foreign purchases of NPLs.

Lengthy approval process

One significant factor has been the inordinate amount of time required for government approvals for foreign acquisitions of NPLs.

Generally speaking, the length of time required to approve a foreign investment in China depends on whether central or local government approval is needed. Local governments approve transactions much faster than the central government. If the investment amount for a particular transaction is less than a prescribed level (currently US$50m for restricted investments and US$100m for other investments), the approval authority generally vests with the local governments.

However, there is a special regime with respect to NPL transactions. The "financial asset management companies" (the "AMCs")[1] are specifically required to seek MOFCOM's approval for any sales of NPLs to foreign invested enterprises ("FIEs").[2] In other words, all NPL deals with FIEs must be approved by the central government regardless of the amount of investment. It is not entirely clear as to why the NPL transactions are singled out for such heightened

scrutiny. What is clear is that this has significantly impeded sales of NPLs to international investors it took the central government authorities a whole year to approve Huarong's first NPL transactions with a Morgan Stanley consortium and with Goldman Sachs.

Apparently in response to the criticism over the lengthy approval process, the National Development and Reform Commission ("NDRC") issued a notice in October 2004 (the "NDRC Notice"). Under this notice, each AMC is required to submit in November of each year its plan for next year's transfer of NPLs to international investors. Afterwards, for each relevant NPL transaction, an AMC only needs to file the transaction documents with NDRC (with copies to MOF and CBRC) within 20 working days after they are executed. For its part, NDRC will issue a Filing Verification Certificate within 20 working days after the documents are filed. With such a certificate, the AMC will be able to register the transaction as "foreign debt" with the State Administration of Foreign Exchange ("SAFE") and the collection proceeds can be remitted outside of China accordingly.

The NDRC Notice sets up a fast track for approval, but it only applies to direct sales of NPLs to offshore entities. For sales to onshore FIEs, approvals are still required from MOFCOM. Even with respect to direct sales, it remains to be seen as to how the new rules will actually be implemented. For instance, two months after the NDRC Notice, SAFE issued a notice of its own (the "SAFE Notice") imposing additional approval requirements on both the AMCs and international investors.

Lack of rules on servicing

The Joint Notice, the NDRC Notice and the SAFE Notice relate primarily to the approvals required before NPLs are sold to international investors. They say precious little about how NPLs will be serviced after they have been purchased by international investors, either directly or indirectly through FIEs. In particular, all these notices are silent as to whether the international investors can establish special purpose servicing companies, as is their practice elsewhere, to service the purchased NPLs.

In the past few years, the Chinese central government issued two notices cracking down on third party debt collection practices in China. The first notice was issued in 1995 by the Ministry of Public Security ("MPS") and the State Administration of Industry and Commerce ("SAIC"), which prohibited the establishment by any entity or individual of "debt collection companies." While the notice does not define the term "debt collection company," it describes the activities of such a company as "undertaking as agent debt-collection and debt-pursuance business, participating as agent in litigation and non-litigation matters without any legal basis and lacking authority and administrative enforcement power granted by law." The second notice was issued by the State Economic and Trade Commission, MPS and SAIC in June 2000. Apart from reaffirming the prohibition against "debt collection companies" contained in the previous notice, the 2000 notice specifically pointed out that companies should not be allowed to disguise their illegal debt collection activities under such pretexts as "business agency" or "financial consulting."

These prohibitions against "debt collection companies" were aimed at disreputable individuals and organisations (some of whom are associated with organised crime) who tend to engage in strong-arm tactics or even violence to collect debts. They typically provide their services to retailers, smaller businesses or individuals instead of banks and large state-owned business. Yet the language of the ban is so broad that literally read it would also include servicing of the NPLs for financial institutions.

The People's Bank of China addressed this problem when it issued a notice in June 2001 allowing the AMCs to "entrust" other entities to resolve the assets of the AMCs pursuant to entrustment and agency agreements entered into between the AMCs and such entities. The notice does not specify who these entities should be, but it does say that the AMCs should in principle use the banks that are the transferors of the original non-performing loans because they "are more familiar with the conditions of the borrowers."

However, there is no regulation which has specifically permitted other owners of NPLs to "entrust" third entities to provide similar service with respect to NPLs purchased from the AMCs. The SAFE Notice seems to have tried to clarify this issue when it specifically allowed international purchasers to use "agents" to register NPL transactions and to purchase foreign exchange when remitting their resolution proceeds. This might be intended to permit offshore investors to act through a local company to service NPLs without necessarily establishing an onshore entity. However, it remains to be seen as to what kind of companies will be permitted to become such agents, as apparently they need to possess the appropriate "business permits".

Other major legal issues

Other legal issues facing foreign purchasers of Chinese NPLs include the following:

Transfer of loans

Under Chinese law, transfers of loans under agreements entered into before October 1, 1999 require consent from the borrowers. Such consent, understandably, is difficult to obtain when the underlying loan has become non performing.

Transfer of mortgages

Under Chinese law, mortgages entered into in connection with a loan are automatically transferred with the transfer of the loan itself. However, the transferee of a mortgage needs to complete a new registration after the transfer. The mortgage registration system in many places in China does not allow for a straight transfer of the mortgage. For a transfer to happen, therefore, the original mortgage must be de-registered first before the new mortgage can be registered. Such de-registration often needs the cooperation of the mortgagor, which may be hard to obtain. In addition, as it takes days or even weeks to complete the de-registration and new registration, intervening liens may arise before the new registration is completed. Pursuant to a notice by China's Supreme People's Court, an AMC will not be required to register a transferred mortgage as the original mortgage will continue to be effective in favor of the AMC. Such exemption , however, has not been granted to purchasers of NPLs from the AMCs.

Repatriation of capital

Under Chinese law, a company may not distribute cash representing its registered capital before liquidation without prior approval. Many foreign acquisitions of Chinese NPLs are executed through the establishment of a Chinese company. As it takes months to obtain approvals for reductions in capital, significant amounts of cash may be trapped in China for an extended period of time.

Direct sales by banks

Up to now, only AMCs, not the commercial banks, have been allowed to sell NPLs to international investors, even though the banks still have large amounts of NPLs on their books. In July 2003, China Construction Bank entered into a loan sale and purchase agreement with Morgan Stanley. As of 18 months later the authorities still have not approved this transaction.

Conclusion

MOFCOM officials indicated a few years ago that they are aware of the inadequacies of the current Chinese legal system with respect to NPL transactions and that they were planning to issue a set of rules to specific address these issues. However, MOFCOM has yet to issue such rules. Until such rules or other guidance are issued as to how to address these issues in practice (whether or not through special approvals and exceptions), the pace of foreign participation in the resolution of China's enormous NPL problems will continue to be slow.

1. Currently there are four such companies, i.e., Huarong, Cinda, Orient and Great Wall.
2. This is required under the October 2001 notice (the "Joint Notice") by the Ministry of Foreign Trade and Economic Cooperation (currently the Ministry of Commerce or "MOFCOM"), the Ministry of Finance ("MOF") and the People's Bank of China (whose banking regulatory functions have since been transferred to the newly established China Banking Regulatory Commission or "CBRC").

Howard Chao is the partner in charge of O'Melveny & Myers' Asia practice.
He can be contacted on +8 621 5298 5300
or by email: hchao@omm,com

This article was co-written by Yi Zhang, a partner based in O'Melveny's Hong Kong office.
He can be contacted on 852 2523 8266 or by email: yzhang@omm.com

OPPORTUNITIES IN THE CHINA NPL MARKET

BY JAMES C. OLSON

In recent years there has been increasing interest among international investors in the growing China non-performing loan (NPL) market. China's four state-owned commercial banks (SOCBs) have been under pressure to resolve their NPL problems as a part of the PRC government's efforts to recapitalise the banks and prepare for the opening of the domestic banking market to foreign banks in 2007.

With NPL levels in excess of $500bn, the potential market is greater than the total value of all of the stock and bond markets in Asia, excluding Japan. Unfortunately, after a promising start with the passage of new legislation in 1999 and the establishment of four major asset management companies (AMCs) to focus on disposing NPLs held by the SOCBs, the market has been slow to develop. Activity accelerated in 2004, however, with a number of high profile NPL and asset dispositions, including the first securitisations of NPLs, and positive steps by government regulators to improve the process for foreign investors.

Investment strategies

China NPLs compete as an asset class with NPLs in other countries and alternative investments. Generally NPL investors look for returns of 20 percent or more, and in emerging markets such as China, 30 percent or more is commonly expected. Various cash generation techniques are available to purchasers, such as loan restructuring to renew or increase cash flow, collateral foreclosure and pursuit of remedies to recover proceeds, and repackaging NPLs for subsequent sale or securitisation. The AMCs possess broad powers to pursue NPL disposition and resolution, including sale of NPL debt, equity and collateral to foreign investors. Most of the NPL purchases to date by foreign investors have been from the AMCs, although the SOCBs have entered into direct dispositions with investors as well.

Common issues

Market attributes of importance to NPL investors include the ability to conduct quality due diligence, access to accurate and complete information on NPL portfolios, development of collateral valuation and reliable cash flow methodologies, the ability to track legal title and ownership of NPL assets and access to first-rate servicing, collection and workout capabilities. Their slow development in China, as well as various legal and structural issues discussed below, have been impediments to the development of the market thus far.

Pricing

Various factors affect the price an investor is willing to pay for a NPL, including the credit quality of the debtor, the age of the NPL, the location of the NPL and the type and quality of collateral, if any. Unfortunately, due to the uncertain credit quality of many of the offered NPL portfolios thus far and the difficulty in obtaining accurate and complete information, satisfactory pricing has been difficult to achieve. While the PRC government has sought pricing on NPL sales at 20 percent of face value or better, the resulting prices paid to date have been lower than anticipated. Other factors bear on the price negotiations as well. The SOCBs are limited in their ability to dispose of NPLs at prices below their net book values and there are concerns about the balance sheet effect of substantial write-downs on their capital positions. Transfers of NPL collateral or "settled assets" appear to be less difficult to price, as such assets are not subject to the limitations on discounts applicable to loans.

Structures

A common feature in NPL dispositions, including NPL securitisations, is the use by the purchaser of a bankruptcy remote special purpose vehicle (SPV) to hold NPLs and NPL assets.

Investing through an onshore SPV

Foreign investors may use an onshore SPV such as a foreign invested enterprise (FIE), which may be a wholly-foreign owned enterprise or an equity or contractual joint venture with a

Chinese party. In each case, the investor faces several legal and regulatory issues.

Capital
While an investor may contribute capital to a PRC enterprise using a debt-equity swap arrangement and acquire assets directly from domestic PRC enterprises for contribution to a newly-established FIE, it is not clear under PRC law whether a foreign investor may contribute creditors' rights in the form of acquired NPLs or equity interests in a domestic PRC enterprise holding NPLs to a FIE established to own and dispose of the NPLs.

Business scope
A FIE's business scope does not normally include the purchase and disposition of NPLs, an area traditionally reserved under PRC law for banks and non-bank financial institutions. Absent special regulatory approvals, it is not clear whether an onshore SPV may be able to fully cover NPL dispositions in its scope of business.

Investment limitation
Although a FIE may invest in other Chinese companies or enterprises, its total equity investment in such other companies generally may not exceed 50 percent of the FIE's net asset value. This may limit a foreign-invested SPV's ability to resolve NPLs through the purchase of equity in other Chinese companies.

Foreign exchange
A FIE's ability to repatriate its earnings from NPL disposition activities may also be limited. Without special approvals from the Ministry of Commerce and the State Administration of Foreign Exchange (SAFE), PRC corporate law and foreign exchange controls limit the ability of a foreign-invested SPV to repatriate proceeds to its investors from disposition of its NPLs, short of liquidating and terminating the SPV.

Investing through an offshore SPV
Many of the legal issues associated with an onshore entity can be avoided through the use of an offshore SPV vehicle, although a number of different issues must be considered.

Foreign debt registration
A foreign SPV purchasing NPLs will be required to register the debt with SAFE.

Foreign exchange
Beginning in January 2005 foreign investors are now permitted upon approval to convert RMB earnings from NPLs purchased from the AMCs into foreign currencies for remittance out of China.

Foreign investment prohibitions
If a debtor engages in an industry sector in which foreign investment is prohibited, the offshore SPV would be prohibited from holding equity in a PRC enterprise obtained as a result of restructuring the NPL, including a debt-for-equity swap.

Special governmental approvals have been important thus far to foreign investors in the China NPL market to solve many of these issues. Unfortunately, the approval process can be lengthy, complicated and uncertain.

Securitisation of NPLs
Securitisation has proven to be a successful NPL resolution technique in many jurisdictions and the development of a market in China would expand the number of potential investors and accelerate the NPL resolution process. Recently completed securitisations have sparked interest and offer promise towards further development of the market.

NPL securitisation structures
NPL securitisation structures are evolving, but usually involve the transfer of a pool of NPLs, together with collateral and enforcement rights, to a SPV which issues notes to investors. The proceeds from the sale of the notes are used by the SPV to purchase the NPLs. The SPV contracts with a special servicer to service the NPLs and forward cash recoveries to the SPV, which are used by the SPV to fund principal and interest payments on the notes.

Credit enhancements can be added to support the notes, such as overcollateralisation, senior-subordinated note tranches, reserves, guarantees and additional high-quality collateral. Other support is added in the form of servicer advances or back-up liquidity facilities to make up periodic cash shortfalls and to ensure timely payment of note interest to investors.

NPL securitisation issues
The regulatory and legal issues applicable to onshore and offshore SPVs used to purchase NPLs are equally relevant to NPL securitisations. Additionally, the ability to establish a bankruptcy remote limited purpose SPV that will withstand a legal challenge is critical to investor acceptability and obtaining a credit rating for the transaction. While offshore SPV structures are well-known and have passed bankruptcy muster in other jurisdictions, the bankruptcy law applicable to onshore SPVs in China is uncertain and still developing.

Conclusion
International investors are already participating in the NPL market and are eager to expand their activities. The PRC government has shown significant commitment in this area, but additional work is needed to address many of the foregoing issues and open the market in a substantial manner. Many hope that further legislation and regulation will be forthcoming soon to resolve a number of these issues and aid the process. ■

James C. Olson is a co-chair of the Corporate Finance Practice Group at Heller Ehrman.
He can be contacted on +1 (415) 772 6391
or by email: jolson@hewm.com