Deutsche Bank Research

"Non-performing loans" – an established asset class

May 25, 2007

Trading in loan portfolios in Germany

In only four years since the first transactions, trading in non-performing loan portfolios has become well established in Germany. For the banks involved in buying and selling it has become a normal instrument for balance-sheet and risk management; for investors, distressed loans represent an additional asset class.

Interim reports on the new asset class are positive. The manifold advantages for market players are complemented by macro-economic benefits, as trading in loan portfolios improves the allocation of risk and capital.

So far, the vendors have been mainly commercial and mortgage banks, whereas the investors are usually investment banks and private equity funds.

Portfolio composition is also following a relatively standardised pattern. Two thirds of the portfolios traded solely comprise real estate; a very small proportion comprises exclusively corporate loans. The remainder are mixed portfolios.

In coming years there will be a qualitative change in the market. New vendors will appear, mostly savings banks and mutual banks; portfolio volumes traded will be smaller; and, within portfolios, corporate loans will gain in importance at the expense of real estate finance.

At the same time, a secondary market for loan portfolios will emerge. Investors are instigating this new option. Instead of liquidating the portfolios themselves, purchasers can also resell at least some of them.

www.dbresearch.com

Author
Stefan Schäfer
+49 69 910-31832
stefan-a.schaefer@db.com

Editor
Bernhard Speyer

Technical Assistant
Sabine Kaiser

Deutsche Bank Research
Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Director
Norbert Walter

Portfolio trading rounds off the credit business

A new instrument for controlling risk and capital

Allocating loans has always been one of the central pillars of the banking business. Traditionally this marked the start of a long-term relationship with the client, which would continue at least until the maturity of the loan. In instances of default the bank itself took over the collection or financial restructuring. In most instances this is still the case today. However, the market is changing: In order to optimise the structure of their assets and the application of their capital, in the last few years the German banks have increasingly been divesting loans. These can either be individual loans or whole portfolios; corporate credit or loans to private households; and the loans may be secured or unsecured.

"True sale" vs. synthetic transactions

In principle, two types of sales of loans are possible: Under so-called synthetic transactions, only the credit risks are transferred, the loans themselves remain on the bank's balance sheet. This is unlike so-called "true sale" transactions: In this case the whole loan, together with any collateral that exists, is transferred to the purchaser, who becomes the creditor. In the last few years, true sale transactions involving loan portfolios have caused a public stir and have prompted action both by the courts and the consumer protection organisations. This article should contribute to the objectivity of the discussion about loan portfolio transactions and will describe their advantages for the banking system and the national economy.

Portfolio trading is being standardised

The sale of loan portfolios – like their securitisation – has now become a normal instrument of banks' credit risk management, in particular for risk- and capital management. All market participants – purchasers, vendors and service providers – are adapting to a routine. Procedures are being increasingly standardised. The accompanying expansion of institutional and legal conditions – such as the gathering and making available of historic data series and contractual elements – simplify the prevalence and expansion of this business model. This benefits the national economy as a whole, as the allocation of risks and capital is improved.

Focussing on distressed loans

The trigger for the use of loan portfolio trading as an instrument for active control of risk and capital is the trading in distressed loans. This is particularly gaining in importance, whenever the banks have an above-average amount of problem loans on their books. Examples of this were the USA "savings & loan" crisis in the 1980s, the 1990s in Japan following the collapse of the real estate bubble and the financial crises in Asia (1997) and Russia (1998). In Germany, the deterioration in the quality of loan portfolios resulting from the east German real estate crisis and the end of the "new economy" boom has been a major driver of market development. This study therefore focuses on the characteristics of the sale of distressed loans. As there is no standardised definition of the term "distressed", in the following loans that will be described as distressed are those that have either already been called in, or for which the borrower is so far in arrears that the bank has the possibility of calling in the loan.

Legal issues with NPL transactions

In NPL transactions, loans can either be transferred to the purchaser individually, usually by assignment (Asset Deal), or they can be placed in a company that is subsequently sold to the purchaser (Share Deal).

Although share deals are not blocked by banking secrecy and the federal data protection act, these have both long been seen as potential obstacles to the transfer of loans by assignment of claim. Based on court rulings, the barriers have been largely removed. It is fundamentally true, however, that the assignment of bank loans relies on the borrower's consent. Nevertheless, the assignment is unproblematic in particular if the borrower has broken the contract, so that the loan has become distressed. In this case, banking secrecy and the relevant data protection regulations take second place to the interests of the bank.

The legal position for the sale of loans that have been serviced according to contract is less clear. The transferability of the outstanding debt in this case depends on whether the borrower's personal data will be transferred to the purchaser of the loan. In practice, sales of portfolios that also include non-distressed loans are structured in order that no transfer of protected data takes place. According to a Federal High Court (Bundesgerichtshof, BGH) decision in February 2007, the assignment of the loan is however effective even if banking secrecy or data protection provisions have been contravened. However, in this case the borrower has a claim to compensation.

An additional legal question is whether the purchaser of bank loans must be a financial institution and must have a banking licence. As the takeover of bank loans (in exactly the same way as their continued management until maturity) is itself not a banking transaction within the meaning of the banking act, it is not only banks that may buy loans. However, in the past a few opportunity funds have taken over German banks (and therefore also their banking licences). This allows them not only to take over and "workout" bank loans, but also to restructure them or to confer new loans: the latter activity is undisputedly a banking transaction requiring a licence under the terms of the banking act.

The business model as viewed by the purchaser and vendor

Possibilities for dealing with distressed loans

A bank has various possibilities for dealing with loans that become distressed. In principle it must make two decisions: whether or not it wishes to keep the loan on its own books; and whether it wishes to undertake the winding-up or restructuring itself. Fig. 1 shows an overview of the options:

A bank's options for action

	Internal Workout	External Workout
Loans remain on the balance sheet	Workout by in-house collection department	Outsourcing of the servicing/workout
Loans leave the balance sheet	Sale; and continued servicing of the commitment on the basis of a service agreement	Sale; and take-over of servicing/workout by an external service provider

1

— Firstly the bank can keep the loan in its own books and also undertake the “workout”, i.e. the winding-up or restructuring, itself. This is the traditional approach. To this end banks often create specialised restructuring units, who exclusively deal with this task. In doing so the “Minimum Requirements for Risk Management” (MaRisk), which require laborious supervision of problem loans, must be followed.

— The particular requirements for staff and resources can make it advisable to hand over the "workout" to a specialised external service provider, while retaining the loan on the balance sheet.

— The third method, sale of the loan in connection with a service agreement, which leaves the "workout" to the bank although the loan will leave its balance sheet, is really only a theoretical option. After all, banks part with distressed loans, inter alia, because – for various reasons – they do not wish to carry out the "workout" themselves. This is, for example, due to the negative consequences for their own reputation or because of the associated burden on resources. Thus, taking over the "workout" after a sale would be nonsensical.

— The largest non-performing loan transactions so far in Germany have involved the sale of a portfolio and the taking over of the servicing by a specialist service provider, usually one having a close relationship with the investor. This type of transaction will form the focus of the following examination.

The vendor's motives

Improved risk structure and higher earning potential

In principle, it is worth selling a loan portfolio if the sale proceeds would be higher than the net present value of the (discounted) net cash inflows from the portfolio. The latter results from the difference between the anticipated interest and capital repayments and the capital costs, costs of staff in the processing department, the costs of execution proceedings, the investments in the collateral necessary before these can be disposed of, etc. The costs of the "workout" play a major part in this. By employing highly specialised service providers, NPL investors are able to arrive at costs that are much lower than the vendor banks' (see below: "The role of the service provider").

Reducing risk assets

In addition, NPL portfolio sales are based on the same calculation as the sale of portfolios of loans that are being serviced according to contract. In the first place they allow the vendor to reduce the amount of risk assets. In this way banks can improve the capital ratios. Sales of loans can also be an instrument for managing the structure of balance sheets, as they allow the vendor bank to change the structure of its assets by selective reinvestment.

Adjustment of the balance sheet structure…

It is interesting, for example, particularly for regionally active institutions to sell parts of their loan portfolios, in order to reduce geographical risk concentrations in credit transactions. Sales of loans can also reduce the concentration of credit transactions in one, or a small number of, sectors or groups of clients and therefore from dependency on them.

… or increasing profits by targeted reinvestment of sale proceeds

The sale of loans as a prerequisite for new investment of the sale proceeds can additionally serve to increase future profits. This applies if, as a result of the transaction, the bank can either (with the same costs) increase its revenue or (with the same revenue) reduce its costs. The first arises if a bank wishes to separate itself from a stagnating area of business and invest in a growth area with greater revenue potential. Vendors of loans can realise major advantages and at the same time reduce their costs if, for example, they sell peripheral businesses in order to strengthen their core business area.

Risk to reputation based on emotional discussions

Selling loans can affect reputation

The sale of distressed loans can therefore improve a bank's risk structure and increase its earning potential. However, transactions of this nature often have a detrimental effect on the reputation of the vendor bank. The sale of a loan is often seen by clients and the public as a betrayal of trust. It is particularly problematic if an investor starts to wind up the loan and to realise the collateral. Anglo-Saxon investors in particular, together with the service providers they instruct, are accused of disposing of loans regardless of the interests of the borrower and of not being interested in an amicable settlement in individual cases. These accusations sometimes also affect the banks that have sold the loans concerned.

Public criticism is often indiscriminate

In the course of this kind of criticism, it is not only the various economic advantages that are overlooked (see below) but also, a sophisticated consideration of different types of borrowers mostly does not take place. In the case of corporate loans, where the borrowers are experienced business people, it can be assumed that they are able to assess the legal character of a loan contract and, in the event of arrears, to reckon with the transfer of the claims against them to a new creditor.

Lenders have an interest in amicable agreement

If the borrowers are private households, the public discussion there mostly makes no mention of the fact that they had not complied with their contractual liabilities to the creditor bank over a long period before the sale of the loan. In the case of performing loans, the portfolio investors step into the existing contractual relationships. The agreed terms are valid until the end of the loan period, or, in the case of the interest rate, until the end of the interest rate fixation period: in this respect the sale of the loan does not put the borrower at a disadvantage. In addition, it is not in the interests of either the banks or the investors to neglect the financial wellbeing of their clients. Even in the case of distressed commitments, in principle the creditor has a major interest in reaching an amicable settlement.

Different types of loans as a solution?

A differentiation of the types of credit available could ease the problem. In the future, it is conceivable that two types of loan contracts could be offered: One type would be transferable, while with the other type transfer of the debt to another creditor would be explicitly barred. As the latter variant would limit the bank's flexibility and the efficiency of its risk management, it would probably be more expensive.

The purchaser's motives

NPL investors' action options

	Short term	Long term
Loans remain on the investor's balance sheet	Short-term workout	Medium- to long-term workout, e.g. with rising real estate prices
Loans leave the investor's balance sheet	Resale	Sale with increased value

2

Investors consider portfolios to be undervalued

The purchase of a portfolio of distressed loans is worthwhile for the investor if the discounted cash value of the anticipated net returns from winding-up exceeds the price of the portfolio. There can be two reasons for this divergence between the price achieved by the vendor bank and the value of the portfolio to the investor. Either the investor believes that it is capable of processing the portfolio more efficiently than the vendor bank in the short term, or the investor and the vendor bank have different conceptions of the medium- and long-term performance of the loans.

Only distressed loans can be quickly wound-up

The investors' perspective can basically be long- or short-term: they may buy the loans to retain them on their own books for processing or to pass them on. Correspondingly there are the options for action summarised in Fig. 2. It must, of course, be borne in mind that each investor takes over the loans subject to their respective maturity dates. In the case of non-performing loans, which are the focus of this article, it can however be assumed that these have already been called in, or could be called in relatively easily. A workout, at short notice, is therefore always legally practicable.

Reasons for more efficient workout

If the loans are to remain on the investors books until wound-up, there are in principle two possible variants, short-term or longer-term workout. In the case of short-term workout, investors gamble on being able to operate – either alone or together with service providers – more efficiently than traditional banks. At the moment, this business model is dominating the German market. The investors' margin of efficiency results from the following:

— The NPL investors' business model is often expressed by the axiom "the profit is in the purchase". For portfolio appraisal, sophisticated IT systems are used, with data relevant to the appraisal. This involves comparing information from the so-called data room, in which interested parties can view the data, with the particular investor's database (trend of rents, sale prices for condo apartments, default rates by groups of persons and types of household etc.). The aim is to assess the future cash flows from a portfolio so accurately that a possible undervaluation can be identified.

— While the banks traditionally (and as a result of their accounting principles) concentrate on the nominal values of their assets, NPL investors think in net present value terms. This means that they appraise each individual loan according to the present value that it can contribute to the portfolio, either by immediate workout or by finding an amicable solution with the borrower. In addition, they are not dependent on the continuation of the business relationship with the defaulting debtor, for example in order to be able to exploit further cross-selling possibilities.

— Investors, or their associated service providers, can achieve economies of scale. The next section ("the role of the service provider") covers this point.

Mortgage portfolios include speculation on real estate price rises

Longer-term oriented investors also speculate on growth in the value of the collateral on which the loans are secured. This motivation underlies, in particular, investments in distressed mortgage loans, the values of which increase with real estate prices. Investments in such portfolios are therefore, at least in part, a speculation on increasing real estate prices.

Up to now no liquid secondary market for NPL portfolios

If an investor does not purchase a distressed loan portfolio in order to "workout" the loans himself (or to instruct a service provider to do so), he can try to pass them on, either in the medium or long term. There will be no further discussion of short-term disposals (either in the form of a sale or by securitisation) in the following sections. Medium- to long-term transfer takes for granted that there is a liquid secondary market for NPL portfolios. So far this is not the case, although it can be expected in the future.

The role of the NPL service provider

Why are service providers more efficient?

Special NPL servicing or workout companies can provide services for the winding-up of distressed loans both to banks wishing to hold the loans on their books as well as to investors who have taken over a portfolio of distressed loans. In the same way as the basic question as to why it is advantageous for banks to separate themselves from a section of the loan business – dealing with distressed loans – there is also the question of why specialised NPL service providers should be able to manage the handling of these loans more efficiently than the banks themselves. The business model used by NPL investors is based on exactly this improvement in efficiency.

“Workout” as a core business

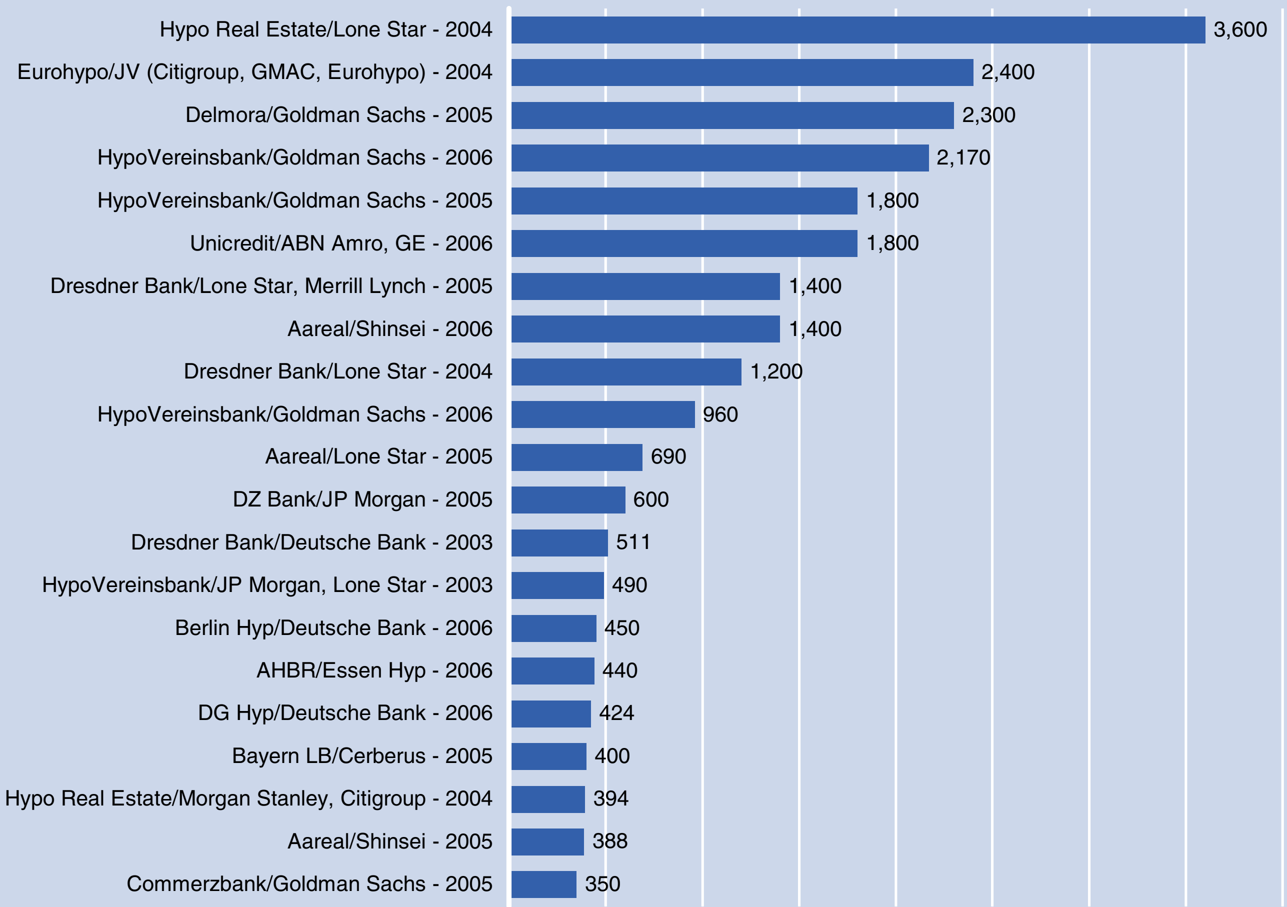
The advance in efficiency results from the fact that handling problem loans is the service providers' core business, while for the banks it is very often only a necessary evil. While the former are able to concentrate their resources completely on this task, the banks' processing departments can easily reach the limits of their capacity, particularly in times of increasing loan defaults. This applies in particular to financial institutions that have not bundled their credit processing in a specialist unit. In contrast, NPL service providers can benefit from economies of scale. They can access specialist staff and a sophisticated IT infrastructure, which is particularly useful during the due diligence process.

Other incentive structures

In addition, the attitude of service provider and debtor is characterised by different incentive structures. Banks in general and primarily regionally-active financial institutions in particular, take their reputations into account and therefore proceed more cautiously in dealing with loans, whereas the service providers can try to assert their interests, or those of their client, more openly in negotiations and – if these fail – in the enforcement of judgment.

The largest loan portfolio transactions in Germany

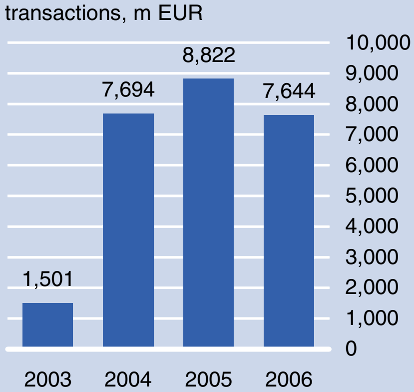
excluding the sale of AHBR to Lone Star, vendor/purchaser - year - m Euro



Source: Press reports 3

What volume of loans has been traded?

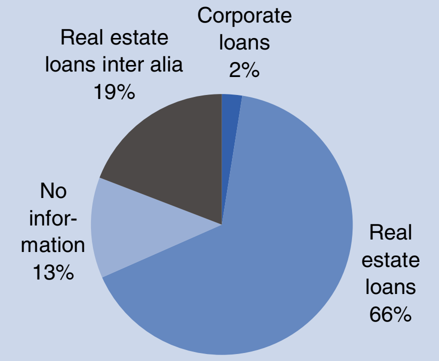
Nominal volume of published NPL transactions, m EUR



Source: Press reports 4

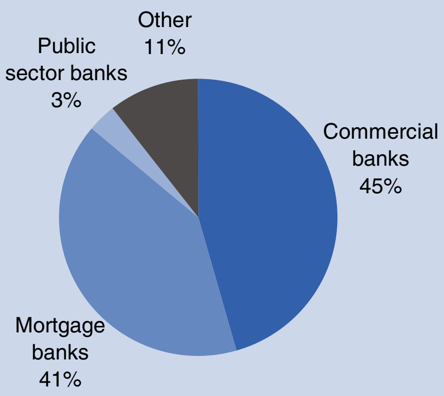
At present, NPL service providers that are usually closely linked with investors – often as their subsidiaries – are dominating the business in Germany. In addition, however, financial institutions who want to carry out the processing of loans themselves are setting up their own service providers. At the same time, the large groups (savings banks, mutual banks) are establishing joint-venture companies, which can provide their services principally to the organisations in the group. Some of these companies are not just NPL service providers but are rather so-called "bad banks", i.e. banks that take over and workout the loans. They differ from the investment banks and private equity investors, who also do exactly the same thing, in the setting of objectives and timescale of their work. They should take over medium- and long-term distressed loans, including their workout, from the group companies. Their focus is not only on the potential returns but also on their contribution to a homogenous group approach to dealing with problem loans.

What loans are being sold?



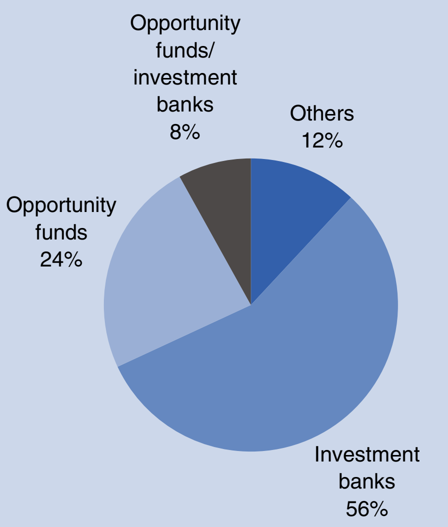
Source: Press reports 5

Who is selling German loan portfolios?



Source: Press reports 6

Who is buying German loan portfolios?



Source: Press reports 7

Last but not least, independent service providers are also being established, although their importance is currently limited.

The German NPL market 2003 to 2006

The market for distressed loan portfolios in Germany has only been in existence for a few years (see Fig. 3 and 4). The first press reports of such transactions can be found in 2003. The following information deals exclusively with large-scale portfolio transactions that have been made public. The dividing line between NPL portfolios and those with properly serviced loans cannot always be precisely drawn. In many cases "mixed" portfolios, or even portfolios exclusively consisting of non-distressed loans, have been traded. In the majority of cases, however, at least a proportion of the loans traded were distressed.

Real estate loans predominate: Almost two thirds of the nominal volume of the loan portfolios sold is accounted for by loans secured solely on residential or commercial property (see Fig. 5). The main vendors are the commercial banks and mortgage banks: the public sector is still under-represented (see Fig. 6). Up to now, the purchasers coming forward have been mainly international investment banks or so-called opportunity funds (see Fig. 7).

Although the volume of transactions is made public, the sale prices for individual transactions are not known, nor are details of transactions that have also taken place but have not been made public. The sale price, expressed as a percentage of the nominal volume of a portfolio, is determined by the quality of the loans involved and their collateral but not least by the quality of information about the portfolio that is available. The better (prepared) is the data, the lower the risk for the buyer and therefore the higher the sale price.

The numbers and volume of NPL transactions that were not reported in the press during the period under consideration was probably still relatively low. This can be explained by the fact that, up to now, very large volumes have been necessary in order to make the transactions viable. The main reason for this is the high fixed costs of IT systems; data preparation and analysis; and legal advice etc. Such NPL transactions, with sale prices in triple-digit millions, could hardly take place without being made public. If the break-even level becomes lower in the future, the number of portfolio sales that are not made public will increase.

The economic importance of trading in loan portfolios

The possibility of selling (distressed) loans gives the banks an additional tool for the active control of risk and capital. This has a positive effect on the whole economy. Firstly, other things being equal, the banks' costs of risk management are reduced. In view of the strong competition in the German banking market, they will pass on at least part of this saving to their clients. Trading in loan portfolios also tends to lead to falling borrowing rates and therefore promotes economic growth.

Optimisation of the control of risk and capital also stabilises the banks' business development over time. In weak economic phases, with large numbers of defaulting loans, loan portfolio trading allows

Stabilisation of the banking system

the banks to quickly clear their books of distressed loans and to reinvest the capital so released. The negative part of the credit cycle, with defaulting loans, loan loss provisionings, stricter criteria for arranging loans, negative effects on investment activity and private consumption and as a result further defaulting loans, will be alleviated. This stabilises the banking system as well as the overall economic trend.

Improved capital allocation, higher economic growth

From the investor's point of view, distressed loans provide an additional investment vehicle. This increases the probability that investors can develop a portfolio allocation that is as close as possible to their risk-return preferences. Trading in loan portfolios therefore improves the allocation of capital as a factor of production and therefore promotes economic growth.

Further development of the European risk and capital market

This applies in particular to the allocation of capital within the European Union. Structural differences between the individual markets mean that it is often not profitable for European banks to set up loan businesses in other EU member states. However, should they wish to diversify Europe-wide, the takeover of loan portfolios from banks in other European countries offers the possibility to do this efficiently. Trading in loan portfolios therefore has not least an effect on the further development of the European risk and capital market.

The future of the German NPL market: Consolidation and diversification

Trading in loan portfolios will change structurally

How many NPLs do the banks have on their books?

Many studies that have examined the future of the German NPL market quote estimates of the total stock of distressed loans on the books of the German banks, in order to indicate the maximum potential for NPL transactions. The two most prominent estimates gauge the volume of NPLs on the balance sheets of the German banks at 160[1] and 300[2] bn Euro respectively. Very different answers are possible to the question as to which of these two figures is closer to reality, depending on the underlying definition of "distressed". However, more interesting than this purely quantitative consideration of the total volume of distressed loans is the analysis of the structural changes in the NPL market.

New vendors are offering smaller portfolios

Savings banks and mutual banks – under-represented so far…

Increasing numbers of transactions are expected from the public (savings bank and Landesbanken) and mutual banking sector. Although one or two Landesbanken (state banks) and the Görlitz savings bank have already become involved, this sector is generally lagging behind. There are two reasons for this: Firstly, it stands to reason that regionally-based banks, such as savings and mutual banks, will handle defaulting borrowers with particular caution: this also complicates the sale of distressed loans. Secondly, the loan portfolios of the savings banks and mutual banks (Volksbanken, credit unions) are often not large enough to be able to assemble a marketable portfolio of loans.

---

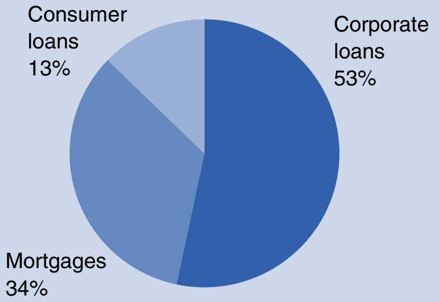
1 Kroll/Mercer Oliver Wyman. A Market for the Making – The German Bad Loan Market. February 2005.

2 Ernst&Young. Global Non-Performing Loan Report 2006.

… but active market players in the future

In future this should be easier. All the market participants are standardising their processes, so that ever-smaller portfolios can be profitably sold. Whereas, a few years ago, amounts in three-digit millions were still being quoted as the smallest viable volume, this has now fallen to the lower two-digit millions. In addition, as already mentioned, "bad banks" and service provider companies are being founded within the groups, in order to achieve economies of scale by bundling loans from the various savings banks or mutual banks in the group. Such smaller transactions will increase in importance at the expense of the large portfolio sales that have so far been dominant.

Distressed loans on the books of the German banks



Source: Roland Berger 8

The composition of the portfolios will change

At the same time, not just the size but also the composition of the portfolios traded will change. As shown in Fig. 8, corporate loans represent more than half of all the distressed loans in Germany, whereas mortgages on real estate account for only just over a third and consumer credit just under 13%. As a result, the proportion of corporate financing in all loan sales will increase while, relatively, the proportion of private and commercial mortgages will fall. This has consequences for the investors' exit strategies, as consideration on a case-by-case basis is much more important for the workout of distressed corporate loans than it is for mortgages. The realisation of the collateral will also become more difficult. Theoretically, distraint on individual parts of a company could replace foreclosure of mortgaged property, although corporate loans are in most cases unsecured. In the case of corporate loans, therefore, (partial) restructuring is gaining in importance as against pure winding-up.

New exit options for investors

New options for investors: resale or securitisation

Finally, a further opportunity for dealing with distressed loans, in addition to the options mentioned (winding-up or restructuring) will present itself to NPL investors. At the moment the use of this is only beginning: resale or securitisation. A secondary market for distressed loan portfolios and thereby also a differentiation of the investors can be expected. In addition to investors who purchase loans and either wind them up or restructure them, a further type, who will hold loans on their books for a period before selling them on, will appear.

Summary

The sale of distressed loan portfolios has become one of the standard instruments of bank risk management. Conversely, distressed loans now constitute an established asset class for investors in the capital market. They provide market participants with additional options and thereby improve the economic allocation of risk and capital.

After years of rapid growth, the market has entered a phase of consolidation and differentiation. Important legal points have been clarified and all those involved are standardising their processes. While the number of billion-Euro transactions is falling, smaller institutions, offering volumes in the two-digit million bracket, are more and more increasing the number of vendors. A large number of service providers are ready to advise banks interested in selling and to take over the management of their problem loans. The type of loans traded is also changing. Whereas at the beginning mainly real estate loans were sold in the portfolios, now individual corporate loans are increasingly coming onto the market.

This qualitative change in the market will play its part in better accommodating the requirements of the market participants. All direct participants as well as the overall economy will continue to gain considerably from trading in loan portfolios.

Stefan Schäfer (+49 69 910-31832), stefan-a.schaefer@db.com

Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg

ISSN Print: 1612-314X / ISSN Internet and e-mail: 1612-3158