As the pace of non-performing loan portfolio (NPL) sales picks up in Germany, an emergent industry is developing in the special servicing of these loans. Once portfolio sales have been closed, there is a huge workout task ahead of the buyer to realise cashflow from the assets as soon as possible. Not surprisingly, competition for expertise in this field has become fierce, and many firms are clamouring for a piece of the action. By **Louise Bowman**.

THE BIG SQUEEZE

Special servicers are challenged with extracting maximum recoveries from the NPL portfolios

Working out a portfolio of non-performing loans is something of a self-defeating task: the quicker you do it, the quicker you are out of a job. But with the volume of non-performing assets in Germany put at up to €300bn (US$400bn), this will take a while. Germany's non-performing debt is estimated to be 60% of Europe's total, and has lured not only private equity buyers but also international consultants to the fast-growing sector – advising on such sales.

Some banks have been cracking on with their bad debt sales. Dresdner Bank's International Restructuring Unit has reportedly reduced its bad debts from €35.5bn to €10bn in two years – and is slated to sell a further €2bn of assets to US private equity fund Lone Star in the near future.

Working out these portfolios is, however, expensive for the buyers. The major international players in the market have tended to bring their "captive" special servicers with them – this is a clear benefit for them as they can potentially get involved in the workout process. Lone Star Funds, which has accumulated approaching €6bn of such assets so far (and has reportedly won exclusivity to acquire a further portfolio of €2bn loans from Dresdner Bank in a deal financed by Merrill Lynch), will shortly complete the acquisition of a German bank – Mitteleuropaische Handelsbank – which will give it its own banking licence. Lone Star's "captive" servicing operation, Hudson Advisors, has been active in Germany since the US-based fund moved into the market, and now has offices in both Frankfurt and Berlin.

Archon Group, Goldman Sachs' Whitehall Funds special servicer, has established a German subsidiary, Archon Deutschland GmbH with offices in Frankfurt, and Morgan Stanley Real Estate Funds (MSREF) has also established itself in the country. Both these servicers have been very active in the Italian

Wulfkin: NPL securitisations will be totally different to those in Italy

non-performing loan market, and had been expected to leverage this expertise in the emergent German market (*see ISR December 2004, page 37*). But the extent to which the Italian non-performing loan securitisation industry can be used as a template for Germany is limited. The Italian market was spurred on by tax incentives, whereas in Germany no such government support has been given.

"Many have approached the German market based on their experiences in Italy and France," observes one London-based banker. "German systems simply haven't been tested for large volumes of NPLs." Steve Williams, executive vice president and head of European lending and investment at GMAC CM in London, agrees that the two experiences are very different: "In Italy, the special servicing of non-performing loan portfolios has become commoditised – in Germany it is not," he says.

Citigroup, Eurohypo and GMAC have taken the concept one step further by forming a joint venture servicing company dedicated to working out non-performing loan portfolios (initially from Eurohypo itself): Opus Servicing Advisors. "The combination of the three parties brought a domestic bank to the table which was extremely important," notes Williams. He explains that the business model incorporates a future co-operation aspect which will involve soliciting third-party business. "This is not a one trick pony," he says.

Under the agreement, around 150 personnel have been transferred from Eurohypo's "intensive care" department to the new company. They are geographically disbursed throughout the country and are managing a €2.4bn portfolio of 14,000 non-performing mortgage loans transferred from Eurohypo to the joint venture (known as the Delphi portfolio).

Global Servicing Solutions, a special servicing joint venture that was set up in 2002 by Ocwen Financial Corp and Merrill Lynch, has also established itself in Germany. But in addition to the "captive" servicers for the large private equity buyers, a number of third-party servicers has also moved into Germany with an eye on the huge volume of workout business on offer. These include LNR Partners (which acquired Hatfield Phillips in August last year) and Crown Mortgage Management. LNR Partners has established a firm in Munich called LNR Partners Germany GmbH and will presumably benefit from its relationship with one of the most active private equity loan buyers in Germany: Cerberus Capital Management. Cerberus subsidiary Riley Property recently acquired LNR Property Corp. LNR Partners is understood to have the mandate to special service a portfolio of just over 800 NPLs to around 400 borrowers.

Crown Mortgage Management is in the process of establishing a third party special servicing operation in Germany, and has a development partnership in place with Frankfurt-based Easetec. The two have put out a joint NPL software product which is a commercial and residential portfolio valuation model.

NPL BUYERS AND THEIR ASSOCIATED SPECIAL SERVICERS

Bank or fund	Associated special servicer
Lone Star Funds	Hudson Advisors
Goldman Sachs/ Whitehall Funds	Archon Group
Citigroup/Eurohypo/ GMACCM	Opus Servicing Advisors
Cerberus Capital Mgmt.	LNR Property
Morgan Staney	MSREF
Merrill Lynch	Global Servicing Solutions
Aareal Bank	Hypotheken Management
Third Party	Crown Mortgage Management

Source: Thomson Financial

The price is right

According to industry estimates, the price being paid for non-performing debt in Germany averages out at around 40c on the euro. But rumours persist that Lone Star paid considerably in excess of this for the Olympic portfolio, the headline-grabbing €3.6bn portfolio of NPLs sold by Hypo Real Estate last year. Bruno Scherrer, head of European business origination at Lone Star in London, declined to return calls by press time. "Your upside is very limited if you purchase for 60c or 70c on the euro," says Henning Schmalz, director, European real estate finance and securitisation group at CSFB. "You damage your economics if you buy at the wrong price."

Private equity buyers are generally looking for a return of 20% or more from such investments, but clearly the longer the workout process takes, the smaller the eventual result. Potential buyers reportedly get four to six weeks to trawl through the data on bad loans before putting in a bid and as the market becomes ever more competitive getting the price right becomes a tricky task.

Some observers have been very complimentary about the speed with which Lone Star established its position in the German NPL sphere. "I think the criticism that Lone Star has paid too much is wrong. They know what they are doing. Gathering all the marbles makes a lot of sense – you have to take a look at the macro-economic situation and make a bet, which is what they have done," says one industry insider. But there is certainly no shortage of competition for the US private equity house in this market.

Working it out

But while the different firms slug it out for workout mandates from the big portfolio buyers, what will they actually do with the assets? "You can try to resolve the loans either on a principal basis or with initial finance but I haven't seen any recoveries from the portfolios as yet," says Schmalz at CSFB. The options include restructuring the loans; negotiating a discounted pay off (DPO) with the borrower; selling the loan on the open market; or foreclosing via the courts.

The strategy taken will obviously depend on what is in the portfolio. And the message that comes across time and again is that each pool of loans is different. "The absence of

NPL PORTFOLIO SALES IN GERMANY

Seller	Portfolio size	Buyer
2003		
Gontard & Metallbank	€225m	Lone Star Funds
Hypo Real Estate	€490m	Lone Star Funds/JP Morgan
ING BHF	€175m	Goldman Sachs
Dresdner Bank	€511m	Deutsche Bank
Deka Bank	€110m	Deutsche Bank
2004		
Hypo Real Estate	€3.6bn	Lone Star Funds
Dresdner Bank	€1.2bn	Lone Star Funds
Hypo Real Estate	€394m	Citigroup/MSREF
Eurohypo	€2.4bn	Eurohypo/Citigroup/GMAC
Sparkasse Gorlitz	–	Lone Star Funds
Undisclosed	€250m	Lone Star Funds
2005 (Pending)		
Dresdner Bank	€2bn	Lone Star Funds/Merrill Lynch (granted bid exclusivity)
Delmora Bank	€2.3bn	TBA
HVB	–	Reportedly inviting offers
Bayerische Landesbank	–	Reportedly inviting offers
NordLB/WestLB	€400m	Transferred to JV for restructuring

Source: Thomson Financial

established servicer platforms and track records, the uncertainties of the size of the market, the burdens imposed on the courts by a surge of loan enforcement proceeds and concerns over collateral values and further declines thereof are not new," noted a group of Standard & Poor's analysts in a report last July on the potential securitisation of German NPLs. "Those who are certain about non-performing loan portfolios are usually wrong. Each non-performing loan market brings its own challenges."

Lawyers at Cadwalader have pointed out that German NPLs tend to be "sub-performing" rather than actually distressed and generally have not been written off by the originating bank but are merely the subject of a major covenant breach. They also point out that relatively few German NPLs are straightforward bi-lateral loans. Many have been sub-participated which can be a headache as the selling bank may not have the right (as majority lender) to direct security enforcement and loan workout.

The goal for the sellers of NPLs in Germany is to try to get reporting standards on these loans to an internationally recognised level. Dixon at CMM says that they want to take the US standard and apply it as a starting point. "You clearly can't apply the US standard to German loans but you can use it as a basis," he says. "The problem is that the systems here are so proprietary. Everyone uses their own system." He estimates that 40% of loans in the market have been written to such proprietary standards. This feeds in to the Commercial Mortgage Securities Association (CMSA)'s efforts to bring a unified Investor Reporting Package (IRP) to Europe.

One servicer estimates that around 40% of the loans in an NPL portfolio that the firm is managing will need to have more complicated workout structures designed for them. "The German lending banks are not streamlined in terms of their borrower or property level reporting and often information such as operating statements and independent valuation reports simply aren't there," he says.

This raises the problem of historical data: it will take time to build adequate historical information on the loans as servicers are often reluctant to rely on the data supplied to them. This could mean that buyers have to hang on to their loans for some time before potential bond investors are comfortable with the information they can provide. But Asina Ajwani, analyst at Fitch Ratings, reckons that the problems that servicers may encounter due to data deficiencies will be limited in the NPL portfolios because of the rigorous selection process undertaken by the buyers. "Due diligence on the portfolio purchases will have been very stringent," she claims. "Only loans where the legal situation and the economic value can be assessed are likely to qualify in the selection process. It is unlikely that investors are going to blindly buy any kind of loan. So data deficiencies witnessed in other asset classes in Germany may not necessarily feed through in the NPL market."

But Schmalz at CSFB points out that the problems faced by special servicers go far beyond those of inadequate data. "Addressing the issue of the portfolios will be challenging," he says. "There are many uncertainties as to how many objections a borrower can make under German law," he says. There is the risk that borrowers could have violated disclosure rules when writing the loans – for example, by paying certain disallowed fees. This seems to be a particular problem for loans generated in the former East Germany.

Problems are compounded when the loan involves a consortium of lenders because of the question of rights to security enforcement and workout (as outlined above). These loans can be very difficult to sort out. The situation can be complicated further when loans are financed with pfandebriefe or the mortgages are second lien. But Williams at GMAC CM points out that "we saw all of this in the US in the early 1990s – there is nothing new under the sun".

SKILLS SHORTAGE

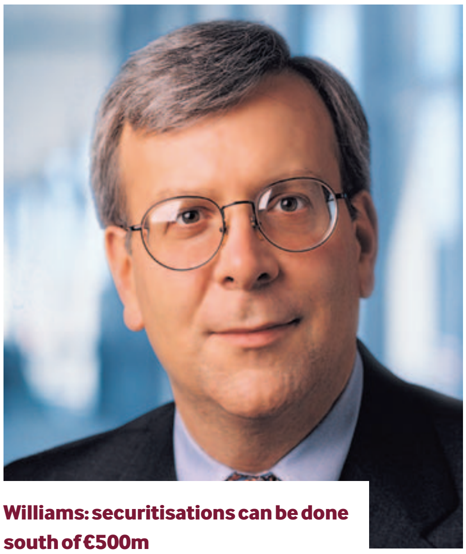
The huge volume of workout work that is now on the table means that companies will be scrambling to hire the best talent for the task. "It is very important to hire locals on your front line," observes Clarence Dixon at Crown Mortgage Management in Frankfurt. Dixon joined Crown from Aareal Bank's specialist servicing subsidiary Hypotheken Management. The question is: where do those people come from? The obvious answer is the German banks, which have been cutting staff and are shedding people from their workout divisions. But these people may not always be best suited to the task as they may be partially responsible for the state of the portfolios in the first place. They also do not have a reputation for being the most flexible of candidates for the job. "The challenge is in combining a general knowledge of processing loans with local knowledge," observes Joerg Wulfken, partner at Mayer, Brown, Rowe & Maw in Frankfurt, who worked on almost all of the early German NPL portfolio sales.

Many smaller loans have been prepared by the in-house legal departments of the originating banks in simple form and just in the German language. This underscores the need for German nationals to be involved in the special servicing process at the direct point of contact with the borrower."There are a maximum of 10 companies fighting for staff in this business," observes Martina Borgmann of recruitment consultants Keinbaum in Dusseldorf. "Most of this demand has taken place in the last six months." She says that while there are people out there with good professional qualifications for the job, spoken English can be a problem. "People have to be fluent in English or they will have problems in an Anglo-Saxon environment," she says, adding that maybe eight out of 10 candidates have inadequate English skills. Candidates can be put off by the "hire and fire" reputation of non-German firms, and it is clear that the business of working out loan portfolios is a finite one. Borgmann has placed candidates with special servicers on basic salaries ranging from €60,000 to €140,000.

"There is a high demand for specialised workout people coming from these firms," agrees Wulfken. Indeed, the law firm recently lost a lawyer to Hudson Advisors as a result. The need for skilled staff will have a crucuial impact on the speed with which some of the larger loan portfolios can be serviced – and thus exited. The Olympic portfolio illustrates the size of the task ahead and questions were raised as to how Lone Star Funds/Hudson Advisors could find enough people to service these loans. The private equity firm has tackled the problem by contracting the servicing of some loans to Aareal Bank subsidiary Hypotheken Management. The latter will commence servicing a €2.4bn portfolio on April 1. The mandate was awarded by Investment Olympic GmbH, a subsidiary of Lone Star. The loans were spun off by HRE into Investment Olympic which was in turn taken over by the US private equity house.

"Germany is an attractive market for investors, and private equity funds seek to realise profits within two to three years," says Alexandre Janicki, managing director at Hypotheken Management. "If you buy a portfolio you need a servicing platform and the seller may not be interested in doing the job." You also need a banking licence – thus Hudson Advisors' acquisition of Mitteleuropaische Handelsbank." The US fund is also understood to be on the hunt for a much larger bank acquisition in Germany. But Hypotheken Management has to hire staff like everyone else. "According to our experience, qualified personnel for NPL processing are not easy to get," Janicki tells ISR. "The German labour market is not as flexible as that in, for example, the UK." Some of the servicing processes can be broken down to reduce the need for hard-to-find specialists. Some initial tasks such as the first or second-time mailing don't need specialised German staff, but at the interface with the client such skills are essential. "The immediate loan workout talent is hard to come by but you can develop it within a one year horizon with incoming staff with German lending and real estate experience," says one US-based special servicer in Germany. The inflexibility of labour rules is demonstrated by the fact that notice can only be given at the end of each quarter and there are strict limits on the length of gardening leave. Williams at GMAC CM believes that hiring the wrong people can be an easy trap to fall into. "People at the workout department of the banks are used to managing provisions from quarter to quarter – that is a very different strategy than NPL specialists are known for," he says. "There are going to be change management challenges in the market where tried and tested methods from other markets are applied in Germany. There is very much a workout mentality – to liquidate the security."

By moving so many staff from Eurohypo to Opus Servicing Advisors as an intact team, Williams believes that the company is protected from too much poaching. But the demand is certainly there. Anecdotal evidence suggests that after Lone Star bought the two huge Hypo Real Estate portfolios (see chart) it "staffed up massively" on the servicing side.



Williams: securitisations can be done south of €500m

Aside from trying to restructure the loan or working out a DPO, the servicer can try a straight sale at auction or foreclosure. "There are many rules governing the foreclosure of a loan and the judicial process can take a long time," explains one special servicer. "It can take many foreclosure cycles to auction these properties to the market." It can take up to a year just to get a property valuation with which to start the foreclosure process. Under German law, the first auction of a loan has to achieve 70% of replacement cost and if this is not achieved the loan cannot be sold. The percentage declines with repeated actions until it becomes an absolute action.

"Servicing these portfolios is a priority for the next three to four years," observes Schmalz at CSFB. "The role of a servicer is to become, over time, obsolete."

In evaluating how many German NPLs will end up in securitisations, it is useful to point out the differences between the German and Italian markets. The early Italian NPL securitisations have performed well but were structured along very different lines to those that are likely to come from Germany.

"In Italy there were a lot of quasi-securitisations where the banks took on a lot of risk themselves," notes Wulfken at Mayer Brown. "Securitisations from Germany will be totally different," he says. The S&P analysts point out that while the primary driver for securitisation of NPLs in Italy was a tax break, there is no such government support driving the process forward in Germany. The sale process in the latter country is the result of the desire of lenders to focus on performing portfolios and not tie up management and resources in working out these loans.

"On the asset management side, what everyone missed in Italy was not the quantum of recovery but the timing," says Williams at GMAC CM. This lesson needs to be taken on board by special servicers in Germany, but events are playing out in a similar way. A big problem in Italy is the number of cases that have become bottlenecked in the court system, and in Germany a similar situation seems to be developing – particularly in eastern Germany.

Any securitisation will be far more complex if it involves a mix of non, sub and performing loans rather than purely non-performing loans. In the early Italian securitisations, the vast majority of the loans in the pools were non-performing. The analysis of such transactions is fairly straightforward as it focuses on the underlying collateral value. The servicer's job is also much more straightforward in an insolvency situation as its strategy is clear: liquidate the loans.

In contrast, the German loan pools involve a mix of loans that are non-performing, those that are sub-performing and those that are on the verge of performing. Generally, a real estate loan is considered non-performing in Germany if interest and amortisation are in arrears by more than 90 days.

The Olympic portfolio is a mixed portfolio. The Delphi portfolio involves purely residential loans but is also a mixed pool. 55% of loans are in western Germany and 45% in Berlin and eastern Germany. The smaller sales have tended to involve purely non-performing loans, but one small sale from an undisclosed bank to Lone Star last October (€250m in size) involved a mixed pool. Because of the mix of assets in the pool there may be a certain amount of slicing and dicing before securitisable pools emerge – but this would necessarily reduce the size of potential offerings.

The collateral mix is also far greater in the German than the Italian pools – involving commercial, multi-family, residential and corporate loans. While this may look attractive as the assets are still income-producing and there is still some kind of liquidity, it makes the correct servicing strategy far more complicated. There are also considerable banking secrecy and data protection issues associated with "live" loans (*see ISR August 2004, page 24*).

"Like with all securitisations, rating agencies want to see as much loan and collateral information as possible including historical data," notes Edward Register, director of the European servicer rating programme at Fitch Ratings. "However, for some servicers, especially third parties, the process of gathering data is proving somewhat difficult." Fitch is the only agency to have published its NPL criteria so far.

The challenges to a German NPL securitisation look substantial, but insiders confirm that one such transaction at least is on the cards for this year. The investment banks are known to have put potential structures to the rating agencies from as early as the middle of last year, but there have been problems with data quality and the uncertainty of the German legal process. Insolvency risk remains from the period of sale to the re-registration of the land charges. This will hopefully be removed on July 1 this year when three new registers will be introduced into the German Banking Act: a refinance register (*Refinanzierungsregister*), a syndicate register (*Konsortialregister*) and a land charge and mortgage register (*Grundpfandrechtsregister*). This will allow insolvency-proof access by a German SPV to the asset pool. Under current legislation a German law transfer of title is required in an insolvency.

"Everyone wants Germany to happen a lot faster than it will," notes Williams at GMAC CM. The NPL portfolios that have been sold will have to substantially de-lever before any securitisation exit and this will take time. Most acquisitions have taken place at around 90% leverage. But not all the portfolios will be de-levered – there are likely to be equity-only exits on the smaller pools.

Working out such loans could take three to four years. Experts suggest, however, that it will take one to two years to sort out portfolios ready for a securitisation exit. One servicer reckons that the economics of securitisation will only work for an aggregate portfolio of more than €1bn, but Williams at GMAC CM says that it can be done "south of €500m".

The generally held view in the market is that if the buyer wants an exit tied to securitisation then they will want to see a rated servicer. But few of the captive companies active in the German market so far are rated. Observers believe that the sheer size of Lone Star's exposure to German NPLs means that the firm will inevitably seek a securitisation exit at some stage. Indeed, potential structures backed by loans from the Olympic portfolio are understood to have been submitted to the rating agencies as long as nine months ago. Will the fact that Hudson Advisors isn't rated be an issue?

Intriguingly, Register reveals that the agency "has been talking to a number of servicers in the German market about current servicing environment and the benefits of a servicer rating". It may be the case that buyers intent on a securitisation exit will get their servicers rated to keep potential investors happy.

Bankers caution that the kind of challenges that these portfolios present mean that securitisation may not always be a cost-efficient option. In the end, a straightforward syndicated loan might be just as attractive. But if and when the long-anticipated first securitisation does hit the screens, insiders predict that execution will "unbelievable". "It will be very interesting to see where the sweet spot is for investors," says one.

Dixon: Use US standard as basis