



THE GLOBAL



As the world begins to emerge from the devastation caused by the global financial crisis of 2008, pension funds and other institutional investors are being inundated with proposals from distressed asset investors attempting to raise capital to invest in non-performing loans (NPLs) and distressed assets around the world. The purpose of this article is to help institutional investors better understand global NPL markets and to select the most appropriate NPL platforms.

GLOBAL MARKET

For Non-Performing Loans

During the past two decades, the market for non-performing loans has been transformed from a small fragmented market that existed primarily in the United States into an active global market. Investors who have the skills, infrastructure, and institutional desire to successfully complete NPL transactions will be in position to achieve strong gains as today's NPL investment opportunities compare positively to the best investing periods for NPLs over the past 20 years. Given the depth and breadth of this market, roughly estimated by Global Distressed Solutions LLC and *The Economist* to be between \$3 and \$4 trillion, investing in NPLs is well worth considering for pension funds and other institutions.

Historical returns for NPL investors have varied, but investors typically demand annual returns (IRR) in excess of 20%. However, when an NPL market is first developing in a country or region, outsized returns well above 30% can be achieved due to limited competition, perceived risk, and a lack of transparency in pricing and market information. Similarly, in the early stages of an NPL cycle—for example, when these distressed assets are acquired near the bottom of an economic downturn—returns above the 20% “norm” can be achieved. Over time, however, as new investors enter the market and risk is better understood, prices for transactions normalize in the very respectable 20% to 25% range.



Jack Rodman

Furthermore, as a result of the current financial crisis, today's global NPL market is markedly different from those of the past in one important way: less competition. The largest buyers of NPLs for the past few decades in every market around the world have been investment banks. This is because of their ubiquitous presence, access to cheap debt capital, propensity for risk, and ability to buy and hold large amounts of illiquid loans for long periods of time. However, the majority of investment banks have disbanded their NPL teams (for example, Goldman Sachs, Citibank, and Morgan Stanley), as they can no longer afford to buy illiquid assets in the aftermath of the 2008 financial crisis. In addition, three of the largest players in the NPL market globally are no longer in independent operation—Lehman Brothers, Bear Stearns, and Merrill Lynch. The absence of such firms provides an unprecedented opportunity for other investors with ready capital and longer investment horizons, such as pension funds.

Where to invest in the global NPL market today is largely determined by how individual governments have managed their domestic economies and financial markets in the global economic crisis. The bailout programs in the United States have generally kept NPLs on the balance sheets of U.S. banks, but many European governments have enacted policies to incentivize, and in some instances compel, their banks to dispose of their NPLs.

The disparate nature of the European Union means that its 27 individual nations are unable to address the current NPL problem with a single uniform approach, and thus some European nations offer better opportunities than others. Regardless, the size of the EU's NPL market is estimated at more than €500 billion (\$738 billion) and growing, making it the largest actionable distressed market in the world today, with outsized returns likely available in many EU countries over the next 12 to 18 months. The United Kingdom, Germany, Italy, and Spain are recommended target markets.

China may also be another emerging NPL market, albeit later than Europe. As a result of the government's fiscal stimulus and a lending boom, China is currently and surreptitiously developing a massive supply of NPLs and is likely to reopen its stalled NPL market to foreign investors 18 to 24 months from now as this new wave of NPLs emerges. Pension funds seeking to invest in China face some daunting challenges, including lack of pricing and information transparency as well as a labyrinthine

bureaucracy. But returns could be strong for those that can navigate the difficult waters.

In the United States, the NPL market likely will be dominated by the large financial institutions that receive "taxi medallions" from the federal government. In addition, (1) governmental policies are not encouraging a quick repricing of the assets, (2) there is substantial experienced talent working on the "supply side" of the equation, and (3) government participation will act to regulate windfall gains. All these factors make it less likely that outsized returns will be achievable in the United States.

Europe

The European NPL market originated during the mid-1990s when Sweden and Italy began selling distressed loans in response to their financial crises. Since 2003, activity in the European NPL markets has been strong, particularly due to the recent global financial crisis. In 2008, the European NPL market was estimated at more than €500 billion. Exhibit 1 illustrates the NPL volumes for 2008 across the key European markets.

Today, there are at least nine active NPL markets in Europe, including Austria, Czech Republic, Germany, Greece, Italy, Poland, Spain, and the United Kingdom, with others poised to emerge. The two key markets to consider are Germany and the UK.

GERMANY

Economic growth in Germany continues to be hampered by a fall in the export markets as global demand for goods has slowed. The economic stress currently being felt in Germany will likely serve as the basis for the next round of NPL sales, which will likely begin in 2010.

The landscape of the German NPL market has changed dramatically since 2003. Notwithstanding the lack of recent transactions, the German NPL market continues to be Europe's largest by a wide margin, at an estimated €200 billion (\$295 billion), according to Ernst and Young's European Non-Performing Loan Report 2008, and the competitive landscape has essentially disappeared as the dozen or so institutional investors that were present as recently as 2005 have either disappeared or withdrawn.

Once the German banks begin selling NPL portfolios again, the pricing levels experienced when this market first became active in 2003 could return. During that prior era, investors were able to earn 30% returns or better, and similar returns could be achieved going forward.

UNITED KINGDOM

The UK NPL market is still in its infancy, with the first transactions being completed in early 2008. But a very large infant it is. With an estimated €107 billion (\$158 billion) in NPLs, according to PricewaterhouseCoopers, the UK represents the second largest market opportunity in Europe. And the €107 figure excludes the amount of NPLs held by investment banks and specialty finance companies. Furthermore, from a competition standpoint, the UK market landscape has remained relatively uncompetitive.

All the sellers of NPL portfolios in the UK to date have been specialty finance companies (such as GMAC) or investment banks. The majority of the global investment banks possessed large residential mortgage origination platforms in the UK, and when that market collapsed, they found themselves holding large quantities of NPLs. These investment banks have been aggressively seeking to dispose of their NPL exposure. The large commercial banks and building societies are also just starting to emerge as sellers of NPLs, as several large commercial banks and local building societies have approached the market for the first time with portfolios for sale. Furthermore, these institutions have expanded the types of loans they are willing to sell and have included corporate loans as well as small and mid-sized commercial loans.

Since the first UK NPL transaction in early 2008, prices have declined for comparable residential NPL portfolios from 70% of par to the mid-30% range. Some of this decline has been a function of more rapid deterioration in the

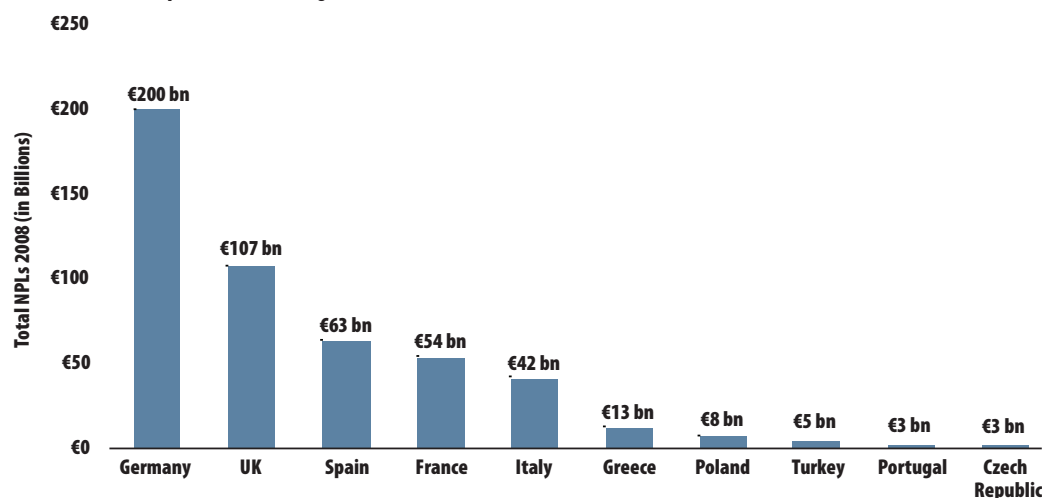
real estate market than anticipated, which has forced buyers to use more conservative underwriting assumptions. But most of the decline is a result of the dislocation in the market and the ability of investors to demand increasingly higher returns. Currently, investors are using 30%-plus return hurdles.

The UK market has the potential to be the most attractive NPL market in the world. The government has nationalized the largest banks and has made clear its intention to bring the assets it has acquired quickly to the market. Royal Bank of Scotland and Lloyds alone have shifted in excess of £200 billion (\$319 billion) worth of distressed and non-core loans into government protection schemes, according to the international management firm Oliver Wyman. Furthermore, the ability as a creditor to enforce rights and recover investment capital is extremely efficient in the UK. This efficiency is unique to any other NPL market in the world in that the majority of the invested capital in these NPL transactions is returned quickly and generally within 12 to 24 months. Lastly, the government has no desire to be a distressed debt investor and has shown this penchant before in the recession of the late 1980s to early 1990s.

United States

In contrast with European nations, and the UK in particular, the U.S. government is addressing the economic downturn by becoming the largest distressed debt investor in the world. Based on past recessions in the United States, the sustained period of bad economic news and massive government in-

Exhibit 1: 2008 European Non-Performing Loans



Sources: PwC Czech, Banque de France, French Banking Commission, BaFin, Jahresbericht 2008, Bank of Greece, Monetary Policy Report 2008–2009, Bulletin of Conjunctural Indicators Feb. 2008, Governor's Annual Report (2007, 2008), Bank of Italy, PFSA, HSBC "Spanish Banks" Report, Bank of Spain, BRSa, Bancscope.

Note: Germany and Portugal 2008 NPL volumes are estimates from Ernst & Young European Non-Performing Loan Report 2008.

interventions in the U.S. financial sector would be expected to create seemingly boundless opportunities for NPL investment. In reality, the opportunities are limited, as the policies implemented by U.S. regulators have left the banks as the best buyers of their own distressed assets for three reasons: (1) They have broad access to extremely low-cost capital from the Federal Reserve and the FDIC unsecured debt guarantee programs, (2) they have limited mark-to-market pressure, (3) the pressure on banks to move assets off their books to increase liquidity has been addressed through the TARP program and subsequent private capital-raising efforts. The announced Public Private Investment Partnership (PPIP) funds for getting toxic assets off the balance sheets of troubled banks has also received virtually no interest from banks thus far.

Opportunities in the U.S. NPL sector thus far have been limited to the sales of securities and limited volumes of distressed whole loans, principally from hedge funds and other non-bank portfolios. The FDIC has resolved a handful of mid-sized, relatively high-profile depository institutions such as IndyMac, but these transactions represent a tiny slice of the total universe of distressed assets. Additionally, to the extent that PPIPs are successful in creating a new class of potential buyers for distressed assets, the high degree of leverage available to them from the government, and the lack of differentiation among them, is likely to create a highly competitive environment. This will tend to favor the sellers of NPLs and drive returns down.

Depending upon the course of the recession and the timing of the economic recovery, a second wave of distressed assets may come on the market over the next 12 to 24

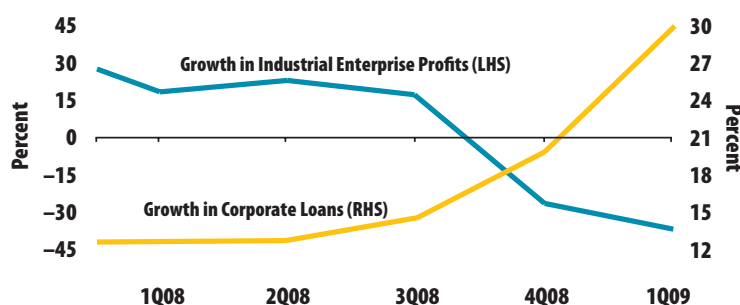
months as unemployment rises, residential loan defaults on higher-quality mortgages spike upward, commercial mortgage loans fail coverage tests and covenants, and corporate borrowers default. The incremental losses and added capital requirements could lead to pressure on the banks to sell or to bank failures that put assets in the hands of the FDIC for liquidation. However, if the U.S. economy is indeed on the mend, as many economists believe, banks will continue to retain distressed assets, and if NPLs are indeed sold, the returns for these NPLs may not be as profitable as they had been in the past.

China

For the most part, the countries in Asia, except China, are all feeling the impact of the global financial crisis on their economies and their banking sectors in particular. However, that is not to say that Chinese banks and the country's financial system are insulated from the current economic downturn. Quite the opposite is true. Despite the positive news banks are reporting, NPLs are likely as endemic in China as elsewhere. However, the banks' ability to defer recognition of NPLs and the government's tight control on the flow of financial information make accurately assessing the situation impossible.

Since their IPO listings and rapid loan growth from 2003 to 2008, Chinese banks have periodically reported negative new NPL formations. Even when the Chinese stock market fell 70% to 80% from its record high, reached in November 2007, and real estate declined 30% to 40% in cities across China, banks still reported only a slight increase in NPLs. The superheated growth in loan originations that resulted

Exhibit 2: Loans to Enterprises Climbing, Despite Falling Corporate Profits (Growth Year Over Year)



Sources: PBOC, CEIC, Bloomberg

from China's economic stimulus and government policy continues to be robust, even amid the global downturn. In the first half of 2009, according to a Fitch China special report, Chinese banks lent RMB 7.4 trillion (\$1.1 trillion), representing loan growth reported by Asia EconoMonitor to be 33%. While no figures exist as to the recipients of all this money, the People's Bank of China's aggregate data shows that more than 90% of the new loans went to corporate borrowers, with infrastructure and real estate companies believed to be receiving the largest share (Exhibit 2).

This increase in corporate exposure has caused Fitch and other analysts concern over asset quality because the steep rise in corporate lending has taken place amid a concurrent substantial decline in enterprise profits. Thus, Chinese bank exposure to future credit losses may be vastly underestimated. Fitch also highlighted "that the recognition of credit losses can take far longer in China than elsewhere due to pervasive rolling over and maturity extensions of loans when they fall due."

While China's economy may not have experienced as severe a downturn as in many developed nations, there will likely be a future robust NPL market. When Chinese NPLs do finally hit the market in 18 to 24 months, a small handful of foreign NPL investors who bought assets in previous cycles and established well-oiled NPL servicing platforms will be in prime position to capture NPL dispositions in China. Foreign investors who would like to participate are advised to identify managers who are well positioned to execute a China-NPL strategy early on, as the universe of well-situated managers may be quite limited.

Three Keys to Success In Today's NPL Environment

1. AVOID OPPORTUNISTS AND CARPETBAGGERS

Regardless of the NPL market, selecting the "right" manager to invest with is a critical success factor. The right manager should have substantial local loan servicing infrastructure, experience, and a track record of success in the local market. While NPL underwriting "fundamentals" are basically transferable from country to country, local laws, business practices, foreclosure processes, bankruptcy rules, and tenant rights all differ—in many cases, dramatically—from country to country. Experience has shown that U.S.-developed NPL skills are not easily transferred to foreign markets, especially to Asia, and China in particular, as language barriers, lack of transparency, and vague regulations whose interpretation is

subject to government policy is vastly different from the U.S. system. Having a local infrastructure in place coupled with previous NPL expertise is key in the successful purchase and servicing of NPLs. While virtually anyone can buy NPL portfolios, only those who know how to service this specialized asset class can earn outsized returns.

2. HAVE ADEQUACY CAPITAL

Capital was not a differentiating factor for NPL buyers in past cycles, but it is today. Getting the deal was key in the past, and all major players had plentiful "opportunistic" capital. Today, having capital in place to execute quickly will allow the first market players to achieve outsized returns for at least 12 to 18 months. As leverage returns to global markets, returns will increase exponentially. The right manager must have long-term, locked-up capital to provide flexibility in resolving NPLs. Often the highest return does not come from a quick exit.

3. CHOOSING THE RIGHT TIME

Finally, the single most important factor in navigating NPL and distressed asset situations is being ready to take advantage of sellers' primary objective: to get distressed assets off their balance sheets as quickly as possible. In many European nations, regulators and accountants have already forced banks to write down asset valuations. Demonstrating to regulators and shareholders that a bank has removed these non-performing assets from its balance sheet increases its ability to raise new capital and has a positive impact on share prices. Flexibility is also key—if an investor is too focused on one particular type of NPL, such as commercial or residential mortgages, such an institution will not be an ideal buyer for a bank that is trying to solve a broader NPL problem.

Pension funds and endowments that plan on making money by buying NPLs must begin preparing immediately. Success requires developing an experienced and localized team in jurisdictions that support disposal of NPLs, having ready capital, and having the wherewithal to jump in early. ■

Jack Rodman is a Senior Advisor to Crosswater Realty Advisors based in Beijing, China. He was the author of Ernst & Young's Global Non-performing Loan Report for 20 years. Rodman has spent the last ten years living in Asia packaging and disposing of NPLs on behalf of government agencies and financial institutions