How to create a positive value loop for Italian NPLs.

We at Crosswater have been watching with great interest the news from Italy on its economy and its fragile banking system. It appears to us that the Italians seem to think that jump starting their sluggish economy and resolving their Non-Performing Loans are separate issues. They are not.

Having been intensively involved in NPL resolution programs in the U.S., Japan, Korea, China and other markets we would like to share some "fundamental truths".

Almost every nation faced with a severe NPL problems initially claims "we are different". Well, perhaps 10% of the problems they face have unique national characteristics, but the remaining 90% of the issues are the same. Because of that it is crucial that governments learn from other nation's mistakes and successes.

In virtually every market that has suffered severe NPL problems, the government and the banks have repeatedly made two initial mistakes: first, they grossly underestimate the number and amount of loans that are presently NPL or a likely to become NPL if the market doesn't quickly recover; second, they greatly underestimate the true values of their NPLs by applying a static or constant dynamic in determining the value of the NPLs. Such flawed analyses then leads to poor decision making and delays that only serve to exacerbate the problem thus making national economic recovery more difficult and eventually more costly to its taxpayers.

If NPLs are not actively managed they inevitably decline in value and thus are an increasing drag on the national economy.

The concept of "warehousing" NPLs in some sort of government created and rigidly controlled entity is deeply flawed and will likely lead to even greater decreases in values. NPLs must be aggressively "worked" with a not insignificant near to medium term profit in mind. Recall that a key, if not THE key , reason for the success of the US RTC program was the Congressionally mandated use of the private sector to execute the program utilizing an incentive driven compensation structure.

When loans are purchased by the private sector, it brings fresh capital to the country and stimulates demand for professional services (accountants, lawyers, consultants, appraisers and loan servicing staff). As the collateral is repaired or refreshed it generates the need for blue collar labor (electricians, plumbers, carpenters, etc). The process itself starts the economic recovery cycle and has the added benefit of restoring confidence in the system.

As a general rule, moving bad loans out of the hands of the people who made the bad loans and into the hands of professional investors and workout people is crucial to any successful resolution. Doing this mitigates "moral hazard".

The "hit" to NPL values does not have to be taken all at once. It can be done in thoughtful steps, and, if properly executed, will lead to the gradual increase in the values of any remaining NPLs. The esteemed Chairman of the US RTC, the late William Seidman, advised recalcitrant banks that in disposing of their NPL portfolios, that "their first loss will be their best loss" as the early transactions will accelerate the recovery process.

Investor confidence in the structure, design and staffing of an NPL program is crucial to drawing in the outside capital which will stimulate the national economy. While countries capital and tax regimes may differ slightly, investor objectives are similar and highly characteristic with an overwhelming emphasis on IRR (internal rate of return on invested capital). Another often overlooked "key to success" is providing investors with quality due diligence and assurance that there is a "level playing field" and that the bid process is fair and transparent. A highly experienced, reputable and trusted Financial Advisor can greatly enhance investor participation and stimulate investor bids.

Experienced outside investors – who have been active in multiple markets around the world – will not enter a market only to "catch a falling knife". They are too smart and too experienced for that. The more professionally designed and managed an NPL disposition program is, the lower the risk to the investors and thus the higher the value placed on the NPLs being offered.

Furthermore, experienced investors who can drive up the value of NPLs will not enter a market for a one-off transaction. The competitive bidding process is the key to driving up NPL values. Therefore a successful program must offer a predictable and organized series of transactions over an extended period of time to attract multiple investors. The highest bidder will win a single portfolio, but the losers will become more aggressive in subsequent portfolio auctions.

It appears to us that the Italian government has gotten themselves into some sort of "negative value loop". Poorly (i.e. unrealistic) pricing of NPLs coupled with a hesitancy to recognize what must be done and poor execution of their so far meager NPL disposition programs leads only to further losses on the loans which then leads to a continued sluggish economy which then inevitably leads to further losses on the loans. That negative loop needs to be reversed.

To jump start the Italian economy authorities must reverse that mindset and recognize that the sooner an effective NPL resolution program (including carefully phased write-downs) is implemented, the sooner sophisticated outside investors will enter the market. History show us that values will then gradually increase, the national economy will begin to recover and thus more money will come into the market and values will continue to increase. We call that a "positive value loop."

Time is the enemy when it comes to NPLs.

Jack Rodman & Ted Leary

Crosswater Realty Advisors

Los Angeles, CA