An overview of how you can assess and address the potential challenges relating to NPLs, from NPL strategy to operations, IT, people and change.

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1. Executive summary

The market for non-performing loans (NPLs) has been growing continuously over the past decade because credit quality has been deteriorating across the globe. While there have been positive signs in some markets, such as the EU as a whole, there are still some countries, such as Italy, Portugal and Greece, which are increasingly struggling with NPLs (see Figure 1 and Figure 2).

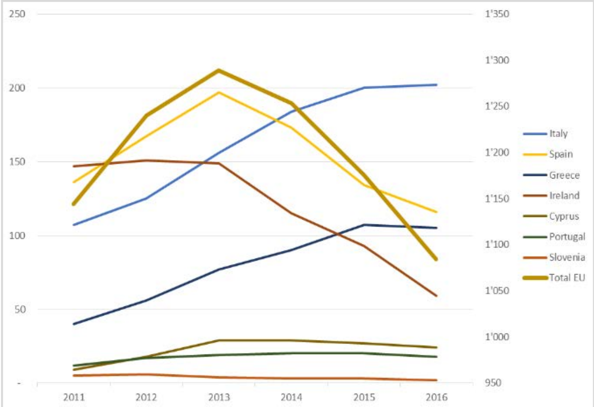

Figure 1: Gross NPL stocks (EUR billions) 2011 to 2016 of high NPL countries in Europe (left axis shows countries' stock of NPLs and right axis shows EU's total NPL stock). Source: PwC analysis1

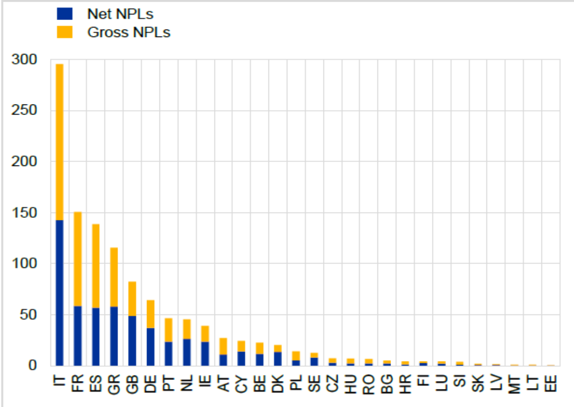

Figure 2: Gross and net NPLs in 2016 in Europe (EUR billions). Source: ESRB[2]

This white paper aims to give you an overview of how you can assess and address your potential challenges relating to NPLs, from NPL strategy to operations, IT, people and change. We summarise our observations, experience and understanding of financial companies' activities to optimise their NPL management. A key point is elaborating approaches to assess your NPL landscape (portfolio processes, KPIs, staff readiness, etc.), the subsequent NPL strategy design and its implementation. We outline our recent experiences with NPL actors in Europe, which have helped us gain a solid understanding of the needs of the NPL market and stakeholders' expectations and how these interact and interdepend as well as how banks, and other market participants should approach NPLs. We extend the view beyond the simple management of NPLs to implications of current regulation (the European Central Bank's guidance and IFRS 9) and how these create opportunities that can help institutions improve their overall business. We present potential solutions to the challenges of NPL, which we have gathered from our work. We lay out how well-defined quantitative and qualitative long-term objectives under appropriate portfolio segmentation and with specifically developed strategy options and early warning indicators (EWIs) as well as a decision tree for the strategy options and well-trained/experienced staff are all key elements to reduce NPLs successfully.

In this way, we hope to provide you some ideas to help you build expertise in your business to improve NPLs and general loan management. Implementing the suggested options (strategically and operationally) can increase profitability by means of a strategic NPL reduction accompanied by maximum recovery.

We also point out the main risks of selecting the wrong strategy and how they can disadvantage your company. We present two case studies to help you understand what the risks are and how taking the right action can make a substantial difference. Finally, we link the NPL market's and investors' expectations to individual institution's activities. This ties into the wider economic impact of the current NPL situation in Europe and the NPL market situation.

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[1] PwC, May 2017, *Market update Q1 2017* (link)
[2] ESRB, July 2017, *Resolving non-performing loans in Europe* (link)

2. Introduction

Non-performing loans and, more generally, non-performing exposures (NPEs) have gained attention globally because stocks have become unsustainably capital intensive. They pose an increasing risk to banks in terms of continuing as going concerns and operating normally. This risk will eventually manifest itself through rippling effects beyond the banking sector because of resource misallocation. On the one hand, individual banks with large NPL portfolios are forced to divert resources that are needed elsewhere and they fail to fulfil their strategic ambitions and economic duty to support viable business financing. Capital that could be used to finance and drive sustainable businesses is tied up in non-performing ones and thus is not productive. On the other hand, NPLs can inhibit banks' lending activities on a larger scale because of the capital they tie up, thus affecting entire economies and their growth.

The origin of NPLs is twofold. First, banks finance businesses and consumer activities that eventually become unprofitable. Second, banks fail to enhance their internal setups to deal with market, economic, and customer changes as well as fraudulent activities by banks and customers. It is fair to say that the NPL issue is now a systemic one, although the solution likely has to be implemented by each bank on its own, with guidance from external stakeholders, regulators and banking associations. The European Central Bank (ECB) issued its guidance on NPL strategy in March 2017[3]. The ECB's guidance encompasses all of the aspects that banks with substantial NPL portfolios should revise. It is, however, up to each bank to develop the details in line with its specific situation.

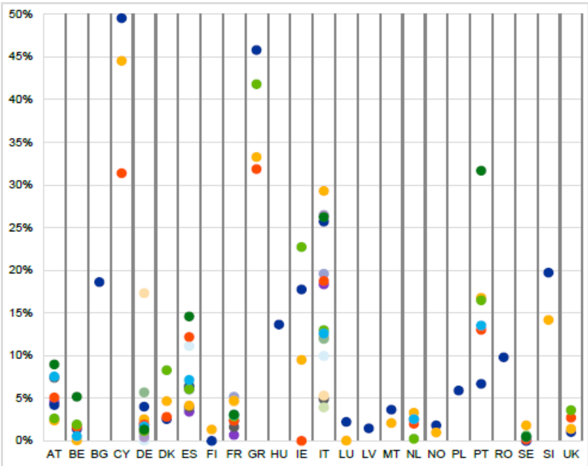


Figure 3: Distribution of NPL ratios in EU countries in 2016 (% of gross debt instruments) (source: ESRB[2])

What are the main causes of NPLs and why are they still a problem?

Economic downturns are often seen as one of the main causes of lower debt and collateral quality and higher stocks of NPLs held by banks. The cause are mainly low GDP growth, high unemployment rate, banks' lending practices, low bank covenants, credit culture in the country, interest rates, supervisory and legal frameworks, etc.

In fact, it's a combination of the external factor (changes in the economy) and internal factors (a bank's governance, risk management and overall culture) that expose a bank to risk of lower loan performance because of unforeseen and badly managed changes in its debt-servicing capacity.

NPLs are also a problem for banks that shy away from the difficult but necessary steps to reduce their exposure. Often, hard choices have to be made relating to governance, processes, write-offs and people management. In our experience, banks that have accepted the reality and taken up the challenge by building a forward-looking strategy based on observable market changes and by implementing suitable

[3] ECB, March 2017, *Guidance to banks on non-performing loans* (link)

operational changes (e.g. setting up a strong workout unit staffed with experts) have managed far better their NPLs. They've also shored up their viability as going concerns and their resilience to poorly performing loans in the future (e.g. by upgrading their credit risk and scoring models, upgrading their IT and data management, and improving the training of their staff – front to back).

A recent ECB survey appears to show that the two main external impediments to resolving the NPL problem for banks are currently the lengthy and costly insolvency process and the inefficiency of the NPL market (see Figure 4).

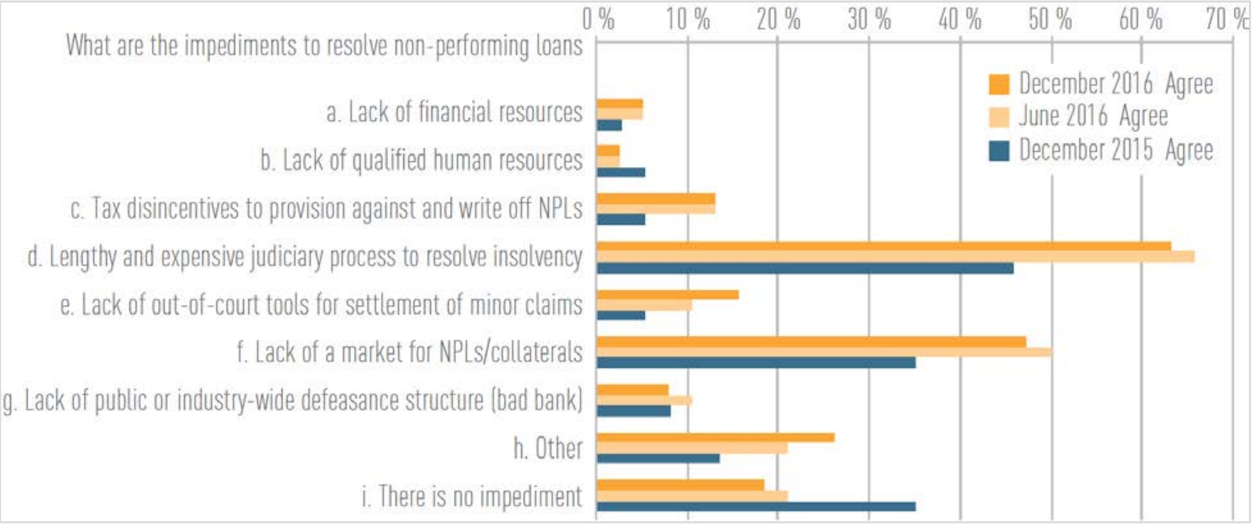


Figure 4: Impediments for non-performing loans resolution are still dominated by lengthy and costly judiciary insolvency process and the inefficiency of the NPL market [4]

Many financial institutions still face data quality issues, which is one of the reasons for the inefficiency of the NPL market. Inadequate data means that banks cannot provide investors with the robust information they need and makes NPL trading pricey.

The main NPL data quality issues that banks currently face are:

- Lack of historical data, track record of exposures.
- Discrepancies between loan documentation and data records.
- No or incomplete documentation.
- Poor collateral data and valuation methodologies.
- Non-compliance with regulatory requirements (e.g. ECB reporting on NPL stock for banks, BCBS 239, etc.).
- Frequent changes in data sourcing procedures, which leads to discrepancies in data quality.

[4] ECB, December 2016, *Risk assessment of the European banking system* (link)

3. The right NPL strategy – the key to resolving the NPL issue

Both the ECB's guidance and general good practice based on experience appear to suggest that every bank has to understand its portfolio, operational readiness, client base and market in order to formulate its own optimal strategy for NPL management. While there is a range of options, there is no magic bullet. Hard work is needed from the analysts up to the C-suite to define a strategy and implement it operationally.

It is also important to note that a strategy's operational realisation can change over time and that parts of it are likely to be diametrically opposed (e.g. incentives and remuneration). On the one hand, an efficient and quick reduction in NPL stocks is demanded. On the other hand, workouts might be more effective, but they take more time and carry operational risks. Workout managers must also be encouraged to reduce their NPL portfolio even though this actually means they are making themselves redundant!

What are the main NPL strategies? The ECB suggests the following general strategies for NPL portfolio management.

Strategy	Description	Advantage	Disadvantage	Applicability
Write-off	The bank writes off the NPLs that are recognised as unrecoverable. The impact is immediate and eliminates future risk and potential losses. The loans are removed from the balance sheet and 100% loss goes to P/L.	Quick; low effort; can be done for individual line items; position is immediately removed from balance sheet.	High loss.	Small items; items that would require disproportionate amount of work; items that are recognised as unrecoverable.
Sale	The bank sells to a bank or another professional investor a sub-portfolio of NPLs that it recognises as unrecoverable. Depending on the arrangement, the exposures are either removed from the balance sheet or go off-balance sheet. The bank accepts a haircut but recovers some part of the exposure essentially immediately.	Quick; low effort; higher recovery than write-off; item is immediately removed from balance sheet.	Needs negotiations with counterparties; significant loss is likely (high discounts).	Portfolio of items with similar or identical parameters; homogeneous groups (e.g. retail real estate, credit card debt).
Hold, Forbearance	The bank holds the exposures, accepting current non-performance under the assumption that conditions will change within a reasonable time and the exposure will become performing again. The exact approach depends on the operating model, the forbearance policy, the borrower assessment, the available operational NPL management capabilities, and available external service providers.	Low effort; potential for improvement.	Risk of greater exposure.	Larger or more complex items; items that have potential for recovery.

Strategy	Description	Advantage	Disadvantage	Applicability
Workout	Workout is an active hold strategy whereby the bank restructures existing loan agreements to optimise recovery. Workout requires a detailed borrower profile, financial analysis, cooperation and a business viability assessment along with sophisticated monitoring processes in the bank.	High recovery.	High effort; needs appropriate processes and people in bank (use of resources, expertise).	Larger or more complex items; items that have potential for recovery
Change of exposure	Foreclosure, debt to equity swap, debt to asset swap, or collateral substitution.	Good potential for recovery.	Medium effort; needs appropriate processes and people in bank; potential for further loss.	Works best for specific exposures; legal process (in court); time consuming and costly.
Legal actions	This includes insolvency proceedings and out-of-court solutions.	Good potential for recovery.	High effort; needs appropriate processes and people in bank; potentially lengthy proceedings and uncertainty about the outcome.	Larger or more complex items; items that have limited potential for recovery; time consuming and costly

Table 1: The potential strategies for NPL management

As the above table shows, there are various general strategy options available to manage a bank's NPL portfolio. Management should consider all of them because it is likely a combination of these options is the best choice, at least for a well segmented portfolio. Clear roles and responsibilities regarding the different related activities must be set up in the organisation. It should also be noted that, on an institutional level, there are further options to create the framework under which the bank operates. The bank can, for instance:

- **Enter a joint venture**, in which it shares the risk and the performance of the NPL portfolio with a third party but keeps the NPLs on its balance sheet. The joint venture partner would have the opportunity to invest in a bank's NPL portfolios without owning them and it will inject capital into the joint venture platform (a special purpose vehicle or SPV).
- **Partner with a servicing provider for NPLs** (workout, restructuring, foreclosure, etc.), which would allow the bank to free up internal resources and return them to its core business activities. This may also provide advantages in terms of alternative accounting and tax options.
- **Securitise the NPL portfolio** by transferring it to an SPV, which then funds the assets by issuing tranches of securities to external investors. Some EU governments guarantee or co-invest in more senior tranches (e.g. in Italy, the senior tranches of some banks' securitisations of NPLs have been guaranteed by the government).
- **Sell NPL portfolios to a national asset management company (AMC).** This option is available only in a few countries that currently have a national AMC.
- **Sell NPL portfolios to investors**, hence removing the NPLs from the balance sheet after agreeing on the price of the NPLs. However, efficient pricing (bid/ask spread) remains a problem in most markets.

ECB guidance and requirements for NPL management

The ECB guidance[5] provides constructive points for banks to start and to improve NPL management and its operational realisation, which includes the main components described in Figure 5 below.

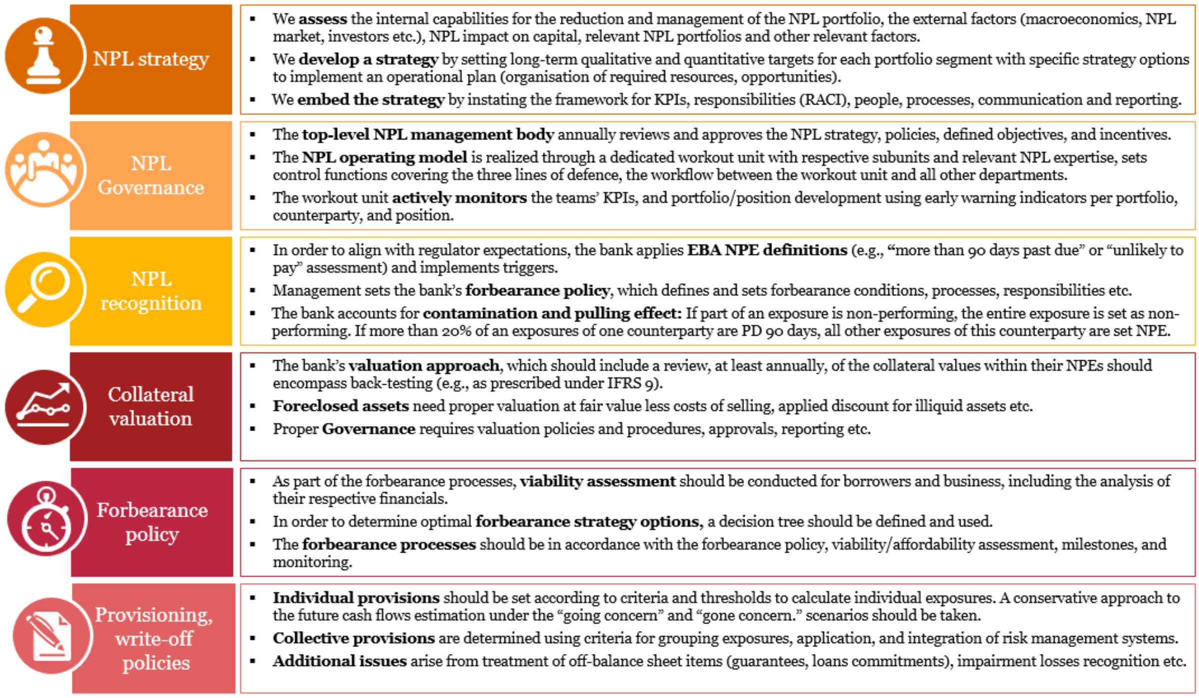


Figure 5: The main components of the ECB guidance on NPLs

The ECB's NPL guidance is non-binding and aims at identifying the best practices banks and financial institutions should incorporate in order to reduce their NPL portfolios. The ECB asks banks to define "realistic and ambitious strategies". A number of individual ('high-NPL') banks received a communication from the ECB asking them to establish clear targets for the reduction of their high-NPL levels over realistic but sufficiently ambitious time horizons. These banks should lay out, for each relevant portfolio, a clear, credible and feasible NPL reduction plan covering the bank's approach, objectives and action plan.

[5] ECB, March 2017, *Guidance to banks on non-performing loans* (link)

Six-step approach to address the ECB's guidance

In line with the communication, the key elements for an effective NPL reduction strategy are the following:

Step	Description
1. Define NPL strategy	• Set **long-term** (at least five years) **quantitative targets** for the global NPL portfolio and each sub-portfolio (the ECB defines seven types of portfolios divided into two main groups: non-financial corporate and households). • Define and **implement strategy options for each sub-portfolio**; possible to define a top-down/bottom-up strategy for a certain number of high-NPL cases.
2. Embed strategy	• Implement **board and risk committee meetings** to review objectives and NPL strategy on a monthly/quarterly/annual basis. • **Hire specialists** and experienced workout officers. • **Implement an incentive scheme** for the workout unit in order to achieve the NPL reduction plan's objectives. • **Enhance data quality** of the NPL portfolios and their collaterals to offset potential bid/ask price spreads.
3. Design TOM	• **Design a target operating model** (TOM) and align it with the workout unit's activities (organisational structure, processes, human resources, etc.). • The definition of the TOM will require analysis of external providers' **internal capabilities**.
4. Apply strategy decision tree	• Create a **decision tree for the strategy options** and implement it in the workout unit's day-to-day NPL business decisions (see figure 3).
5. Develop and apply policies	• **Tailor the forbearance policy** and strategy for maximum recovery. • **Follow a provisioning policy** in line with the NPL reduction strategy (enhancement of the coverage ratio, IAS 39/IFRS 9).
6. Measure and refine NPL management	• Set **monthly KPIs for the workout unit officers** (individual reduction of the gross NPL, cash collected, recovery rate, etc.) and **for the NPL management efficiency** monitoring (e.g. NPL/total loans ratio, NPL coverage ratio, cure and re-default rates, etc.). • **Review of the credit analysis and covenants** in the loan origination process (lower LTV, higher debt service coverage ratio, collateral requirement, credit score prerequisites etc.) – to solve the NPL issue at one of its sources

Table 2: The key elements for an effective NPL reduction strategy. Note that step 6 to 1 is a feedback loop.

As explained in the six-step approach (see table 2 above), implementing and applying a strategy options decision tree in the workout unit's day-to-day NPL business decisions is a key step to address the ECB's guidance on reducing NPL stocks. Figure 2 below is an example of a strategy options decision tree example.

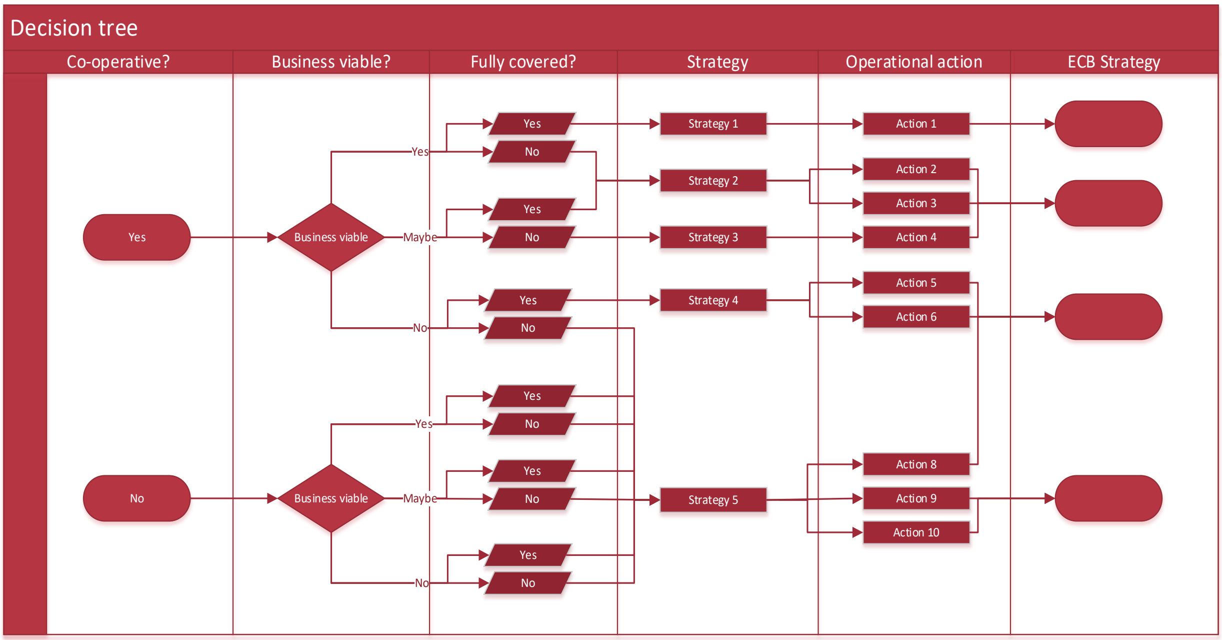


Figure 6: Example NPL strategy options decision tree

4. What are the risks of choosing the wrong strategy?

Choosing the wrong NPL strategy can result in low cash recovery due to the inefficient selling prices and thus a shortfall in overall revenue for the bank. For example, omitting to assess the credit score or business viability of the counterparty of an exposure can result in the wrong strategic choice and in a loss of revenue for the bank. For instance, it might choose to sell (lower price and expected recovery) when a proper assessment would have suggested a hold strategy that yields higher future cash flows. On the other hand, holding an NPL portfolio instead of selling it through divestment/active reduction can increase the capital and liquidity requirements (e.g. decrease in the CET1 ratio with an increase in the RWA, a potential decrease in the LCR and NSFR liquidity ratios) and unnecessarily tying up internal resources (the workout unit and other departments involved).

When making a strategic NPL decision, banks should take care to follow a clear analysis and decision process with regard to their NPL strategy options (i.e. use of a decision tree, derive the available options and align with the portfolio objectives) and the best practices set out by the ECB's NPL guidance.

Case study 1: Greece – a spiral of loss

Since Greece was hit by the financial crisis in 2010, its banks have been recapitalised three times: the last round in 2015 for a total of EUR 43 billion. However, the balance sheets of Greek banks are still in bad shape, being severely impacted by the high number of NPLs (the ratio of NPLs is about 40%[6]). So why does Greece still have this high NPL burden?

Although Greek banks have agreed to an NPL reduction plan[6], in the beginning of 2017 the gross NPL stock spiked at almost EUR 1 billion due to the enduring economic recession. Many borrowers refused to repay or agree to restructure their loans in the hope that the government would come to an extrajudicial compromise in the near future that might improve the contractual terms and debt haircuts. Moreover, the deferred tax credits (DTCs) related to NPLs remain an issue because they can be counted as capital regardless of whether the banks make a profit or a loss, thus reducing Greek banks' capital quality.

Greece liberalised its NPL market in 2015 with the aim of attracting foreign investors but this has not happened yet due to the remaining economic uncertainty. The creation of a national AMC could be another option to attract fresh foreign capital to the Greek NPL market. However, the uncertainty about the economic future of Greece has to be resolved first if this objective is to be achieved.

Case study 2: Balkan region – hold out vs. fire sale

In 2012/2013, the Balkan region was hit by a severe economic downturn, which later affected the banking system by impacting loan quality and increasing the stock of NPLs held on bank balance sheets.

Some banks reacted hastily and sold their NPL portfolios at steeply discounted prices to outside investors (NPL management funds[7,8,9]). Recent ECB risk reports suggest that the overall amount of NPLs on bank balance sheets has decreased. It is likely there are still considerable volumes of NPLs that are now with private

[6] Bruegel, February 2017, *Should we worry about Greek banks?* (link)
[7] Euromoney, July 2015, *Emerging Europe: NPL sales pick up in CEE* (link)
[8] Reuters, June 2015, *Apollo, EBRD to buy Slovenian bank NKBM* (link)
[9] SeeNews, July 2016, *Slovenia's NLB to sell portion of bad loan portfolio for 396 million euros* (link)

investors, thus increasing the banking sector's 'safety margin' to some extent. Nevertheless, the total amount is still some 15%, which means that at least some banks are holding onto their NPLs. Why?

Given that most loans are likely securitised by real estate, the 2012 downturn caused real estate prices to fall and, in turn, increased loan to value (LTV) ratios leading to balance sheet impairments.

However, the real estate market has been recovering and it shows strong signs of further recovery. This will lead to decreases in LTV ratios (depending on efficient portfolio management, of course) and, thus, the improvement of loan portfolios. Banks that held their NPLs and companies that bought NPL portfolios early on are likely to benefit from the current economic upturn. Their portfolios have significant potential for recovery, supporting the hold decisions made in 2012 and 2013.

The wider economic impact

The current situation risks the development and stability of parts of the EU – and the EU as whole – if the resulting problems become contagious (e.g. by affecting investors such as pension funds). The current European stock of NPLs has deep structural causes and is partially a legacy from the last financial and economic crisis, during which asset quality issues have been highlighted (asset quality review). The growth in NPL stocks has revealed the limited capacity of the EU banking system to deal with distressed debt. A number of banks in countries across the euro zone currently hold high levels of NPLs – the so-called 'high-NPL banks'. The ECB, which is responsible for the stability of the European banking market, has summarised the experiences of banks under its supervision with NPLs in its recently released NPL guidance[10] (March 2017). This guidance was published to help the management of EU banks establish and further develop best practices for their NPL strategies and operations. The ECB requires high NPL banks to establish and integrate a clear and ambitious NPL reduction strategy that includes:

- specific long-term targets,
- a range of policy options,
- an operational plan, and
- overall governance structures.

The ECB expects a purposeful and sustainable reduction of NPLs on high-NPL banks' balance sheets to promote the economic stability from a microeconomic and macroeconomic point of view and restore confidence in the banking sector. According to the ECB's latest Financial Stability Review[11], the NPL issue is quite heterogeneous throughout the EU. Moreover, Vítor Constâncio, Vice-President of the ECB, still sees the resolution of NPLs as happening only slowly.[12]

In the present paper, we describe the current market, recent observations about the origins and causes of NPLs and, more generally, their various manifestations as well as the different approaches to handling them.

[10] ECB, March 2017, *Guidance to banks on non-performing loans* (link)
[11] ECB, May 2017, *Financial Stability Review* (link)

[12] Speech at *Tackling Europe's non-performing loans crisis: restructuring debt, reviving growth event* organised by Bruegel, Brussels, February 2017 (link)

The current situation in Europe

The present low interest rate environment continues to challenge for banks in terms of generating sustainable profits and, in some European regions, profitability expectations continue to be weakened by the large stock of NPLs that has been built up.

Despite the fact that EU AMCs were set up to transfer the NPLs from banks under restructuring (NAMA in Ireland, SAREB in Spain, and BAMC in Slovenia), 107 significant institutions (SIs) in Europe still held NPLs for a gross amount of around EUR 866 billion at the end of 2016 (the total European NPL burden exceeded EUR 1 trillion for the same period[11,13]).

The NPL reduction has been slow and heterogeneous with double-digit levels in six of the most impacted euro zone countries. In terms of scale and size, banks directly supervised by the ECB still held EUR 921 billion of such troubled loans at the end of September 2016, which represented 6.4% of total loans and nearly 9% of the euro zone's GDP)[12].

In 2016, European banks held EUR 2.3 trillion of loans they no longer wanted, of which around EUR 1 trillion were NPLs and EUR 1.3 trillion were performing. The value of the European non-core assets rose due to the continued restructuring of the banking sector resulting in more assets being designated as non-core.

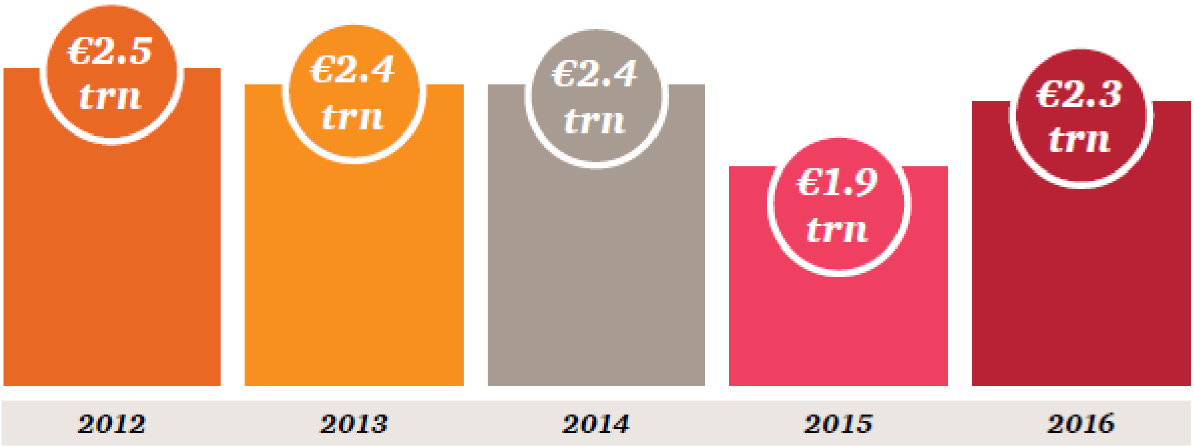


Figure 7: European banks non-core assets evolution (source: PwC analysis[14])

[13] PwC, May 2017, *Market update Q1 2017* (link)

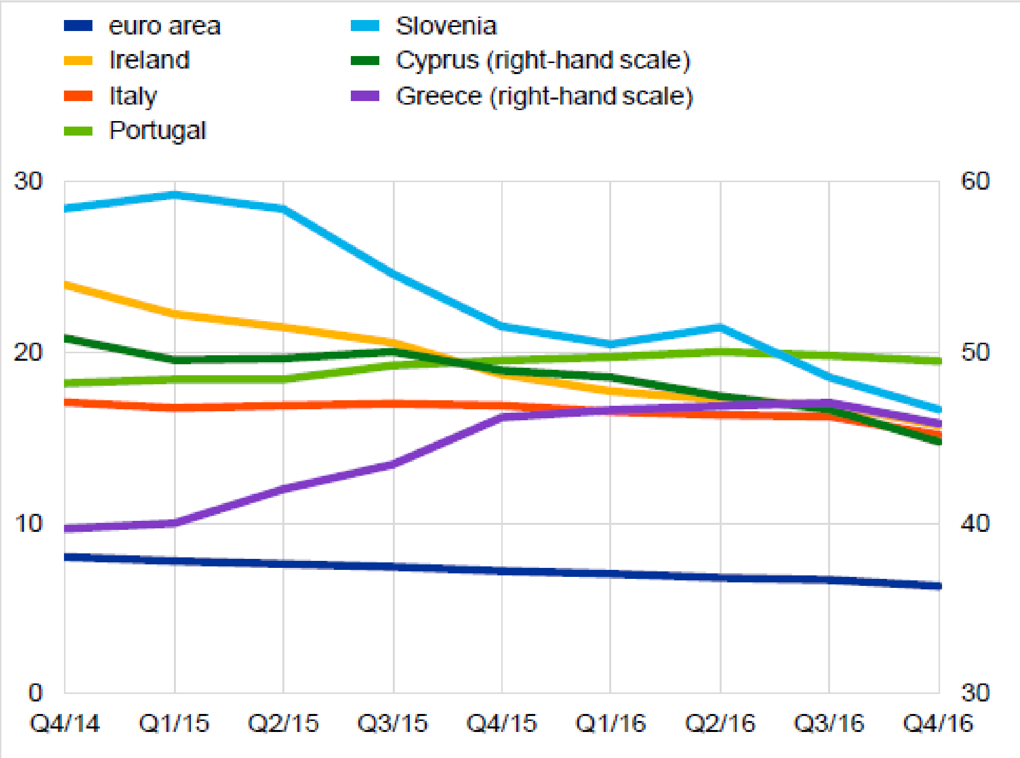


Figure 8: Non-performing exposure ratio in the euro area countries (Q4 2014–Q4 2016; percentages, euro area aggregates)[11]

Despite a decline in the second half of 2016, following an increase in write-offs and portfolio sales, the NPL to total exposure ratio (NPL/total credit exposure) in the high-NPL countries still remains high, whereas the euro area average continuously declined from December 2014 to December 2016 (ca. 6% in Q4 2016) (see Figure 8).

The EU's NPL level remains higher than other major developed regions. For the US and Japan, the World Bank reported NPL ratios of about 1.5% at the end of 2016. In the aftermath of the global financial crisis, the recognition of losses has been slower and more gradual in Europe than in the US (NPL ratios peaked in 2012 in the EU compared with 2009 in the US).

The EU member states that were most affected by the financial crisis experienced major increases in their NPL ratios. The most impacted euro area countries in 2017 are Cyprus, Greece, Ireland, Italy, Portugal and Slovenia.

By the end of December 2016, the two countries that had to implement strict capital controls, Greece and Cyprus, reported NPL ratios of 46% and 45%, respectively. The four other most impacted NPL countries (Ireland, Italy, Portugal and Slovenia) all reported NPL ratios between 15% and 30%, while the other EU countries had NPL ratios below 7% (see Figure 8).

However, the NPL coverage ratio (NPL provisions/gross NPLs) currently stands at 82% on average for the euro area as a whole (Q2 2017, ECB), which is promising.

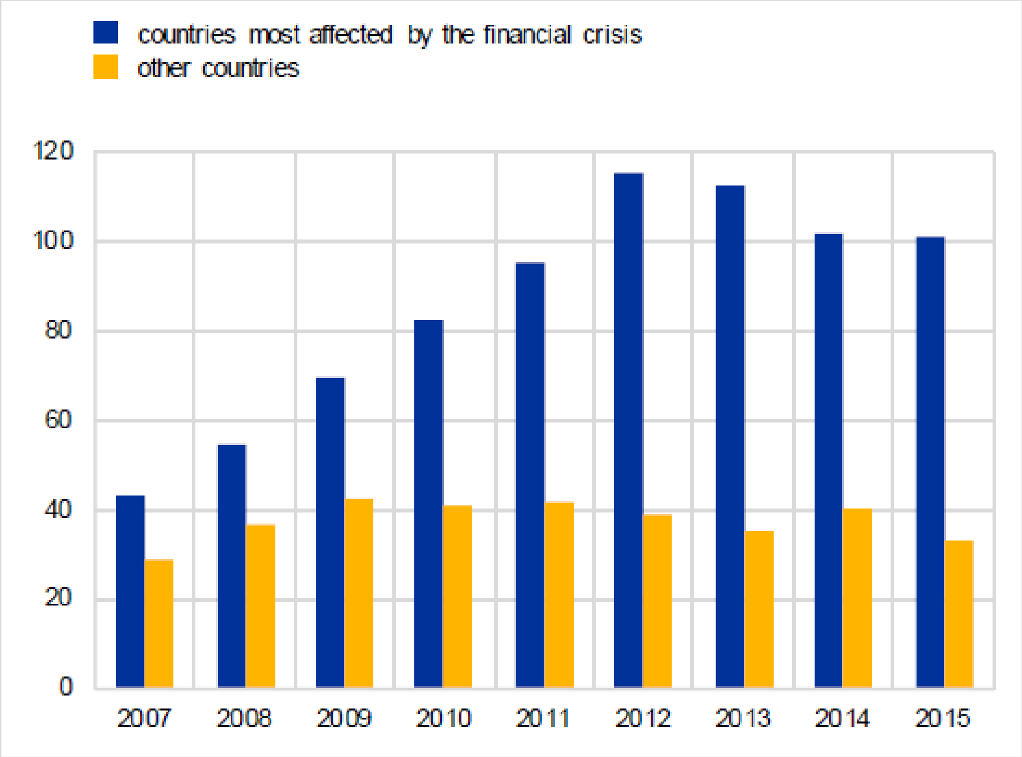


Figure 9: Texas ratio comparison between the high-NPL countries and the other countries in Europe (2007–2015; percentage; median values)[11]

As shown in Figure 9, the Texas ratio (NPLs/tangible common equity) was still above 100% at the end of 2015 for most of the affected European countries. A ratio above 100% means that a bank's tangible equity cannot cover the NPL exposures. Many high-NPL banks in Europe currently still have Texas ratios above 100%. For example, in Italy most of the largest banks have Texas ratios well in excess of 100%. Italian banks made the news in Q2 2017 (Monte dei Paschi di Siena, Banca Popolare di Vicenza and Veneto Banca)[15] because of the increasing unsustainability of their NPLs. Small and medium-sized enterprises ('Non-financial corporations – SME' according to the ECB's classification) are most impacted by NPLs in the EU, followed by large corporates and households.

NPLs have a negative impact on European economic growth: large NPL portfolios reduce profitability, increase funding costs and tie up banks' capital (liquidity), which negatively impacts the credit supply and, ultimately, growth. The NPL problem is currently affecting European banks' profitability and is one of the main reasons for the low return on equity (ROE) across the EU, which is currently around 5% on average and remains below the cost of equity. The European Banking Authority (EBA) sees high NPL levels and low profitability as the main risks of EU banks both now and in the coming years.

[15] PwC, December 2016, *The Italian NPL market* (link)

Market overview

The rise of NPLs has brought about the creation of a secondary market and attracted new market players whose business revolves around buying/selling/trading and the workout of NPLs. Banks are increasingly encouraged by regulators to reduce their NPLs, mainly by increasing the capital requirements for such positions. This has led to the formation of companies specialising in the handling of NPLs. These companies can focus their business activities on the valuation of NPLs and their bundling, processing and monitoring, while this might be financially unattractive for banks. This is even more the case as banks are encouraged to reduce NPLs. Building up effective NPL management departments would be counterproductive for banks in the long run, but beneficial for such NPL specialist institutions. Given the capital intensiveness of NPL trading – banks are usually more interested in offloading large portfolios rather than individual positions – investment funds that provide capital to NPL trading companies have also grown. The illiquid nature of NPLs limits market participants to banks, traditional 'long-only' investors, hedge funds and private equity funds. These investors are also investing in the AMC SPVs. For example, NAMA (Ireland) and SAREB (Spain) AMCs are largely privately owned.

In addition to the ECB guidance, a number of policy options to address NPLs have the potential to deal with related market failures and, ultimately, facilitate the workout or sale of NPLs. One of the key preconditions for the success of these policy options is the improvement of legal processes governing debt recovery.

Amongst the options, which include the establishment of national AMCs and asset sales with the assistance of an NPL transaction platform, the ECB highlights the potential role and benefits of several co-investment strategies (between the private sector and the state) to address NPLs. The main advantage of these co-investment strategies is that they may enable sales that might otherwise not occur owing to the currently elevated bid-ask spreads for NPL portfolios.

The interest of international investors in the acquisition of servicing platforms remains high in order to optimise NPL portfolio sales and management.

The top NPL investors in Europe in 2015/2016 included[16]:

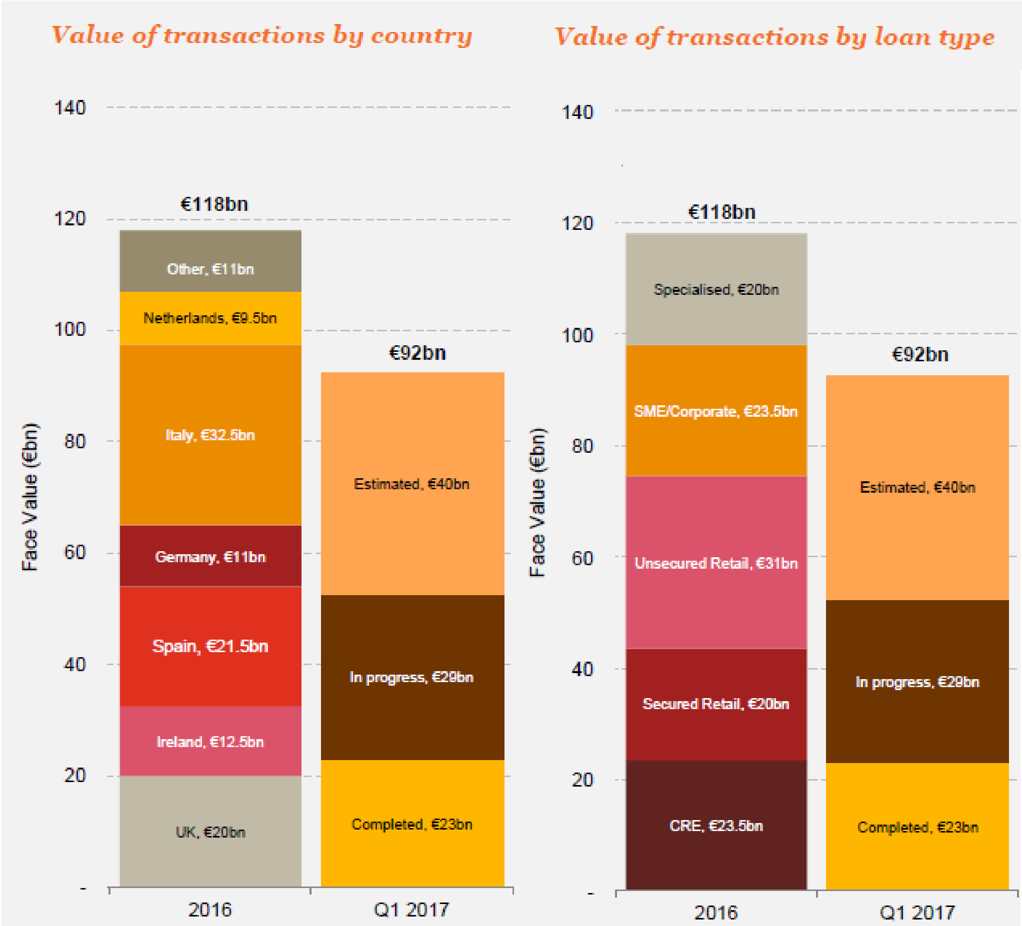
- Cerberus
- Lone Star
- Deutsche Bank
- Goldman Sachs
- CarlVal

The top NPL sellers in Europe in 2015/2016 included[16]:

- UKAR
- NAMA (Ireland AMC)
- RBS
- GE Capital
- Permanent TSB

In Q1 2017, over EUR 50 billion of NPL deals are expected to be completed or are in progress (see Figure 10).

[16] Cushman & Wakefield, 2016–2015, *European real estate loans sales market* (link 1, link 2)



Source: PwC analysis
Note: Based on the location of the head office of the bank selling the assets
'Specialised' includes certain structured and asset backed products, shipping, infrastructure, energy and aviation

Figure 10: NPL transactions from 2016 to Q1 2017 by country and loan type[13]

Various factors are creating gaps between the book value of NPLs (net of loss provisions) and the market prices. Investors may input a series of discount criteria in their pricing, which include:

(a) lack of information, data asymmetries – the selling entity has always more information about the NPLs than the buyers, so a lower bid from investors may reflect this uncertainty;
(b) the estimated potential cost and time to recover the NPL value and its potential collateral, which reduces the NPL price; and
(c) varying expectations for the macroeconomic outlook– a more optimistic view about the local economy may be held by the seller than the foreign investors.

The high NPL supply volume and some very illiquid assets will tend to move the market prices against the sellers. Hence, these bid/ask spreads could prevent some banks from selling their NPL portfolios.

Another potential problem in the NPL market is that various structural impediments may exist in some countries that constrain the development of an active NPL market. This could lead to an increase in cost and time for the sale and collateral execution, and increase the bid/ask spreads (as explained above). Such impediments are not in the banks' control. They include, for example:

- National insolvency regimes that 'overprotect' some types of creditor from legal foreclosure enforcement actions and collateral appropriation (e.g. retail mortgage borrowers).
- No out-of-court restructuring arrangements.
- Pressure from government on lenders and the legal system to avoid foreclosures.

- Legislative limitations on collateral sales of some types of collateral (e.g. residential property).
- Non-bank entities are legally prohibited from purchasing and managing NPL portfolios, thus making it difficult for non-bank companies to enter this market (e.g. in 2015, Greece passed law 4354/2015 to facilitate the sale of NPLs to non-bank companies).
- Lack of overall skills in the legal system to process enforcement actions against non-performing borrowers.

The global NPL market is still maturing and has significant potential for improvement in order to increase market efficiencies for buyers and sellers.

What do the market and investors expect?

In general, the market expects that banks follow the ECB's best-practice guidance on NPLs. However, an efficient NPL market and a balanced insolvency regime (quicker and less costly legal processes) are also anticipated. The market expects more help from the state and central banks in order to deleverage and reduce the NPL stocks by relaxing the bank resolution regime (Bank Recovery and Resolution Directive, BRRD). There are many legal constraints on government ability to create NPL AMCs, including the BRRD resolution framework and the EU state-aid rules.

Expectations are high for the easing of some national NPL regulations to allow, for example, investors that are not banks to enter the local NPL markets. Investors expect less economic uncertainty in the high-NPL countries they invest in, more transparency (i.e. improvements in data quality, fraud, valuation, etc.) and more power to take decisions regarding their NPL portfolios (e.g., as the major shareholder of the bank, partner in a joint venture, etc.).

Banks' lending practices are also expected to improve. Replacing NPLs with new loans that then become non-performing is not a viable solution. Robust and sustainable changes need to be made to the banks' structures. Hence, the market expects a reduction in the NPL stocks, which can be achieved, for example, by applying the ECB's guidance, creating an efficient NPL market and increasing the support provided by AMCs, regulators and central banks. This would allow investors better returns on their investments and increase their likeliness to invest, thus supporting the overall ambitions concerning the management and reduction of NPLs.