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## Non-Performing Loans and Securitisation in Europe

**Considerable attention has centered in the recent past on the issue of non-performing loans (NPLs) in the European banking system. The focus has been less on securitisation as a viable alternative resolution model and more on alternative structures. Against the broader background of new regulatory developments in the Italian NPL market, that came into force earlier this year, this alert examines the basic structure of an NPL securitisation and its pressure points.**

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The amount of NPLs held on European bank balance sheets exceeds Euro 1.2 trillion: a significant portion of the unwanted, non-core and non-strategic assets held by European banks according to some estimates. The resolution of this situation has, so far, been addressed using one of two models. The first is the disposal of NPLs to state-sponsored bad banks, such as Sareb in Spain or NAMA in Ireland. The second is the disposal of NPLs to private investors. Both these solutions involve the banks selling the NPLs recognising a loss (assuming that the sale price is less than the book value). However, they transfer the ownership of and responsibility for resolving the NPLs to the purchaser.

Until the announcement by the Italian government of its state guarantee scheme in February of this year, relatively little consideration had been given to the use of securitisation structures as a means of dealing with the European NPL situation. This might have been driven in part by the continuing negative perception of securitisation as a financing tool, and in part by the impact upon both the sell-side and the buy-side of securitisation transactions of post-financial crisis regulation. The approval by the Italian Government of the new law decree permitting a state guarantee in respect of securitisations of NPLs earlier this year might indicate that the judicious use of securitisation, appropriately structured, could provide another means of dealing with the NPL overhang as well as providing an interesting investment product to at least certain types of investors.

### The Basic Structure

In terms of a basic structure, NPL securitisations are relatively straightforward:

- a bank that originated the NPLs or, in the event of transfer, the lender of record (the originator) of the NPLs, sells them to an unaffiliated vehicle (the issuer) for an agreed purchase price, which is typically less than the face value of the NPLs. The sale should be a “true sale”. This means that the subsequent insolvency of the originator does not result in the sale being adversely affected, through being re-characterised as a secured loan to the originator or on the basis of any other transaction-avoidance rules;
- the issuer funds the purchase of the NPLs through the issuance of debt instruments to investors in different tranches (the notes);
- the cash flow generated by the NPLs is collected and applied on behalf of the issuer in a disciplined manner, resulting in the payment of interest on and the repayment of principal of the notes, as well as the payment of the costs of the securitisation structure;
- the task of collecting the cash flow is undertaken by a third party appointed by the issuer (the servicer); and
- in order to mitigate the risk that the NPLs do not generate sufficient cash flow for scheduled debt service payments to be made in respect of the notes, various structural features (such as liquidity, credit enhancement and hedging) are put in place.

These features are similar to many securitisation transactions. However, the key difference between NPL securitisations and other securitisations is the nature of the securitised assets. In the majority of securitisations, the assets (be they trade receivables, automobile loans, student loans, residential mortgage loans or commercial mortgage loans) generate, at least in theory, stable and predictable cash flows, with debtors making payments in accordance with their contractual obligations. The collection and application of these cash flows, assuming that they arise, is generally straightforward. NPLs are the opposite: in the most extreme case, they do not generate any payments by the debtors that are made willingly. Rather, it is incumbent upon the servicer to take active steps to resolve the NPLs and generate a cash flow. The nature of the NPLs and the legal framework of the relevant jurisdiction are factors that affect the servicer's ability to carry out these functions. NPL securitisations are therefore dependent for their ultimate success on three variables:

- the quality of the NPLs;
- the quality of the servicer; and
- the quality of the servicing environment.

We look at each of these in turn. The enhancement features of an NPL securitisation will be structured taking these variables into account.

### The Quality of the NPLs

It is possible to divide NPLs into two broad categories: secured NPLs, where the loans benefit from security over some form of asset, and unsecured NPLs, where the loans are purely payment obligations of the debtors. The most common form of secured NPL is a mortgage loan, where the loan is secured over either a residential real estate asset or a commercial real estate asset. The most common form of unsecured NPL is a personal or corporate loan. In the former case, the quality of the NPL is, generally speaking, a function of both the value of the secured asset and the robustness of the legal rights the holder of the NPL has in respect of the secured asset. In the latter case, the quality of the NPL is, generally speaking, a function of the payment ability of the debtor and the robustness of the legal rights that the holder of the NPL has against the debtor. These propositions are straightforward. It should be appreciated, however, that neither the value of a secured asset nor the payment ability of a debtor are static – they can fluctuate over time, and the position at the date of the securitisation may become stale quite rapidly. The speed with which resolution is achieved is important. Furthermore, the robustness of legal rights cannot be determined with absolute certainty until the rights are actually exercised and their weaknesses are revealed.

As with any securitisation, examining the quality of an NPL portfolio will involve both commercial and legal due diligence. The due diligence should be backed up by representations and warranties given by the originator to the issuer. In the event of any breach of these representations and warranties, the originator should be obliged to repurchase the offending NPLs at a price that enables the issuer to discharge the liabilities it incurred upon purchase of the offending NPL and the cost of funding them. These representations and warranties are, of course, a matter of negotiation between the issuer and the originator, with the expectation being that the originator's willingness to provide extensive representations and warranties will be limited, particularly where the originator facilitates due diligence in respect of the NPLs.

### The Quality of the Servicer

The quality of the servicer is perhaps the single most important factor in the success of an NPL securitisation. It is certainly possible to assess and form a view on the experience and track record of a servicer in resolving NPLs. It is equally possible to assess and form a view on the human and systems resources that a servicer has available. The servicer can be required to prepare a granular resolution plan to set out how it proposes to approach each individual NPL and what recoveries it expects that can be assessed. Finally, it is possible, via the terms of a servicing agreement, to require the servicer to operate within certain parameters. There can be no assurance, however, that a servicer will achieve any particular outcome in relation to resolving an NPL. This is because of the multi-dimensional nature of the resolution process and the many factors that can affect how a servicer will be required to act.

In broad terms, there are two main approaches that servicers can take in relation to NPLs. The first is a consensual resolution with the debtor, leading to the debtor making a discounted payment in respect of the debt it owes. Accordingly, if an NPL has a face value of Euro 100 but was purchased by the issuer for Euro 70, the servicer, all other things being equal, would achieve a satisfactory resolution for the issuer if it were to agree on a discounted payment by the debtor of at least Euro 70 plus interest to enable the issuer to pay its funding costs and running costs. The second is formal enforcement action, where the servicer exercises the rights it has to extract value from either the secured asset or the debtor itself. This can be a much more protracted process involving the risk of the value of the secured asset deteriorating (in the context of a secured NPL) or the payment ability of the debtor deteriorating (in the context of an unsecured NPL). In our example, if the servicer were to achieve the recovery threshold of Euro 70 plus funding and running costs, this would be a satisfactory resolution for the issuer. A third, less common approach is that the servicer could “trade” an NPL by selling it, on behalf of the issuer, to a third party.

These are all worthy approaches. However, their shortcomings can be illustrated by extending the hypothetical example used above. Assume that the NPL is secured by a commercial real estate asset. The asset has a value of Euro 100 at the time the NPL is sold by the originator to the issuer – quite enough to sustain recovery of the full amount needed by the servicer. However, as the servicer is undertaking the resolution process, one or more occupational leases expire, resulting in the cash flow generated by the asset being diminished. As a result, the value of the asset reduces to Euro 60 (based on the assumption that the value of the asset is driven by the cash flow it generates). In this scenario, the most logical course of action to follow would be to find new tenants for the asset, thus stabilising the cash flow and, as is expected, restoring value. In order to do so, however, there may well be some degree of capital expenditure needed in respect of the asset. The servicer’s challenge would be to ascertain how that capital expenditure would be funded and undertaken. A securitisation structure does not typically have a source of funding available to the servicer for the purpose of undertaking value-enhancing capital expenditure, and, in the absence of surplus rental cash flow generated by the asset, the servicer’s only alternatives will result in sub-optimal recovery and a loss sustained by noteholders. This is not a rational economic outcome. Providing the servicer of an NPL securitisation with an ability to access funding for the purposes of value-enhancing capital expenditure, and giving it the ability to undertake such work, would be an attractive feature in the context of secured NPLs.

In general, servicing agreements used in the context of securitisations impose upon the servicer the requirement to maximise recoveries in respect of the loans that are being serviced. It is left to an individual servicer to interpret the nature of this duty in any particular context and to determine the necessary steps to take. This gives a servicer a considerable amount of discretion in terms of its operations. If a market in NPL securitisations does develop in Europe following the Italian model, one of the more interesting considerations will be evaluating the level of oversight and control exercised by the noteholders over a servicer. While certain types of securitisation transactions allow noteholders to replace one servicer with another, this process has not always been easy to achieve, and the expectation of noteholders in relation to servicer replacement has not always been satisfied.

Servicing of any securitisation transaction is complex. The complexity is heightened in the context of NPL securitisations because of the need for the servicing to be pro-active from the outset. The servicer needs to be provided with the discretion and latitude to exercise and act upon its professional judgement while at the same time being subjected to a degree of oversight, where this is protective to noteholders. These are matters that will require consideration in structuring and documenting NPL securitisations, both in the context of the new Italian regulatory developments and, potentially, in other contexts. Finally, the servicer’s incentives need to be set so that it is willing and able to dedicate the relevant resources to achieving resolution, while at the same time being responsive to prospective Noteholders.

### **The Quality of the Servicing Environment**

If, as described above, a consensual resolution with a debtor cannot be achieved and it is not possible to trade an NPL by selling it to a third party on behalf of the issuer, a servicer’s focus should turn to taking formal enforcement action against a debtor or against the individual secured assets or portfolio. The process of formal enforcement is often complicated, with the degree of complexity being dependant on the legal environment in which the servicer is

operating. Legal environments in Europe differ in terms of how easily creditors can exercise rights, and the ability of the most experienced, well-resourced and well-organised servicer may be limited by the legal framework in the jurisdiction in which it is required to operate. The assessment of an NPL securitisation therefore requires an appropriate assessment of the relevant legal environment, focussing on the frictions that exist in relation to the exercise of creditor rights generally. More important, the focus should also be on the actions that can be taken by a debtor to frustrate the servicer exercising those creditor rights, a “real-world” eventuality that cannot be ruled out. The costs, timing and predictability of formal enforcement action can have a bearing on the ultimate recoveries that are achieved in respect of an NPL pool and are a key consideration in the context of NPL securitisations.

## Conclusion

Prior to the financial crisis, Italian NPL securitisations were one of the earliest types of securitisation undertaken in the European market. The Italian model designed to use securitisation as a tool for resolving the NPL overhang that affects Italian banks, is indeed a development in the European NPL market and the post financial crisis European securitisation market. However, NPLs are a particularly complex asset to securitise and the success of such a transaction is dependent, more than anything, on the operational success of the servicer. It is therefore necessary to give rigorous consideration to the quality of the servicer and the servicing processes as well as the servicing environment in which the servicer operates.

In the series of client alerts that are to follow, we will look at certain other aspects of NPL securitisations. The alerts will cover the legal and regulatory matrix under which NPL securitisations must now be executed and the enhancement features that may be relevant in structuring a securitisation of this type. We hope that this will provide a thorough overview of this product and will be useful to market participants as the NPL overhang in Europe continues to be addressed.

**Ropes & Gray has recent experience in the acquisition and disposal of NPL portfolios in Europe and of using securitisation and securitisation-like financing techniques in respect of a variety of assets. We would be happy to discuss any queries arising out of this Alert with you.**