GARRIGUES

NPLs portfolios and REOs deals: an update at October 2021

LatAm & Iberia – NPLs Task Force (3T 2021)

October 2021

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NPL transactions continued to take off in the third quarter of 2021. A growing interest in NPL securitizations has been perceived, especially in Spain. In Europe, meanwhile, talks continue on two key topics: the draft directive on credit purchasers and credit servicers – which has made great progress –, and talks on the European Banking Association's templates aimed at simplifying NPL portfolio transactions. The gradual disappearance of forbearance programs and other support measures in Latin America, Spain and Portugal are fueling very reasonable estimates on the forthcoming launch of new transactions.

NPL transactions continue to take off

In the third quarter of 2021, NPL transactions continued to take off, although not uniformly or across all jurisdictions, in either number or size of transactions. Transactions in Europe, for example, are still far from pre-COVID-19 figures (€102,8 bn in 2019 and €208,2 bn in 2018, according to Debtwire).

Industry estimates are that the fourth quarter of 2021 will be laden with new mandates for financial advisors to build the next NPL portfolios, because in a number of large markets (United Kingdom, Germany, Spain) sellers have already finished internalizing the end of forbearance programs and other support measures. On September 30, 2020, the UK lifted restrictions on winding-up petitions and creditors can now bring them if their claim is £10,000 or more, although the restriction on winding-up petitions for commercial rent claims remains in place until March 30, 2022. And on April 30, 2021, Germany lifted the suspension of the obligation to file for insolvency for overindebted companies that requested financial support. In Spain the restriction still in force allowing insolvency proceedings to be avoided is expected to end on December 31, 2021, following repeated warnings from the Bank of Spain on the inefficiencies caused by keeping the restriction for longer.

Growing interest in NPL and REO securitizations

While portfolio sales gather speed, a very clear interest has been seen (in Europe and also in a few Latin American countries) in securitization transactions. In Europe that interest has been spurred by the very favorable reform of the rules on NPL securitizations, which we explained in an earlier publication. A sign of this interest in NPL securitizations in 2021 was Oaktree's completion in Spain of one of largest deals of the year (*Retiro Mortgage Securities*)

Draft EU directive on NPL purchasers and servicers

More than a year after COVID-19 burst onto the scene, it is clearly apparent that the pandemic's Winds of change are blowing from the European Union for servicers specializing in recovery and management and purchasers of NPL portfolios. In a meeting on June 28, 2021, the EU Permanent Representatives Committee approved a final compromise text for the proposal for an EU directive on credit servicers and credit purchasers (the "Directive"). A vote in plenary on that final compromise text was included on the agenda for the sitting of the European Parliament on October 19, 2021.

Approval of the Directive may reasonably be predicted for the first quarter of 2022 although it could come earlier considering that the existing text is the outcome of a prior global agreement between the European Parliament, the European Council and the Commission in the “trilogue” process. The truth is, however, in the past (2014-2019) 89% of legislative texts were approved at the third reading and only 1% went through in the first.

Talks on European Banking Association (EBA) templates

In May, 2021, the European Banking Association published a document to take forward the templates review process with which it is sought to eliminate information asymmetries in NPL portfolio sale transactions. The consultation period opened by the EBA ended on August 31, 2021. Various market participants have made comments on the templates, their design, the information fields, the relative importance of a few of them and the barriers and problems for access to a certain class of information. Final approval of the Directive will mean these templates becoming mandatory technical standards (“implementing technical standards” or ITS), so the current work by the AEB and other participants (portfolio sellers especially) is directed at making the templates simpler, more reasonable and more effective, with the aim of having them accessible to the market at the end of 2021.

So, what main trends are already visible in the main LatAm, Spanish and Portuguese markets? What transactions are being performed in these jurisdictions and which have yet to come?

Garrigues is pleased to share our view of the main trends in these debt markets, drawing from our on-the-ground network of offices in Colombia, Mexico, Peru, Portugal and Spain.

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Colombia

NPLs portfolios and REOs deals: an update at October 2021 in Colombia

1. Market update

Despite efforts by the Colombian Government and financial institutions to provide relief to debtors for their payment obligations, the delinquency rate has risen. According to the most recent report published by the Colombian financial supervisor (*Superintendencia Financiera de Colombia*) as of July, the delinquent loans of local banks were 4.7%, up by more than 30% on the same period in 2020.

According to data published by the supervisor, the local and international banks with the highest amounts of money tied up in delinquent loans are Bancolombia (approx. €1,441 million), Davivienda (approx. €938 million), Banco de Bogotá (approx. €800 million Euros), BBVA (approx. €412 million), Scotiabank Colpatria (approx. 343 million Euros) and Itaú (approx. 214 million Euros).

2. Key trends

A number NPL deals completed by some of the main financial institutions have been announced over the past quarter, Bancolombia in particular played an active role in transactions with international investors.

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Spain

NPLs portfolios and REOs deals: an update at October 2021 in Spain

1. Market update

If this was a motor racing competition, it could be said that the NPL market in Spain has returned to the circuit and is making the first laps, building up speed as it goes.

After spending a few months waiting in the pit lane, uncertain about the effects of forbearance and other support measures to confront the COVID-19 pandemic, a number of Spanish banks such as Banco Santander, Caixabank or Abanca have returned to launching NPL sale processes with various types of assets and in a range of portfolio sizes. In a few cases, NPL sales have been organized in more restricted competitive processes, to which only funds that had already participated before in transactions with the seller banks were invited.

There are definitely reasons for optimism over the progress and pace of the NPL market in Spain. The launch of new transactions related to NPL portfolios continued in the third quarter of 2021. One example was CaixaBank launching the first transaction with underlying mortgages since Bankia was absorbed, ("MoMa" Project, €576 million). The secondary market is also starting to gain importance and a few interesting transactions have been completed, such as Intrum's purchase from Cerberus of more than 100,000 loans ("Segura" Project, €1.0 bn). The more traditional sellers have also known when to play their cards with new competitive processes, such as Banco Santander ("Titán" Project, €600 million) or Cajamar ("Jaguar" project, €500 million). Retail loans have even started arriving on the market, such as the portfolio that El Corte Inglés is managing and which includes more than 100,000 transactions related to domestic appliance purchases and credit cards ("Melabosporum" Project, €90 million)

Going forward, a few institutions (European Central Bank, Bank of Spain) have voiced their concern over the templates that Spanish banks are using to provide loans and measure the risk associated with these new funding transactions. In their opinion, those templates show an improvement in the creditworthiness of debtors in sectors that have been hit hard by the COVID-19 pandemic, when that improvement is actually most likely to be due simply to the support measures to confront the effects of COVID-19. It has even been said that future NPL exposures may be being built up due to using biased indicators for arranging loans. The European Central Bank has also voiced its concern over two factors that may increase the level of NPLs: the profitability of the business models of a large number of banks and a failure to adapt their internal risk measurement models to big challenges, such as climate change.

2. Key trends

- **Dynamism on the sell side:** operators seen in the past to be more active on the sell side have already launched selling processes and have prepared new portfolios that have recently been brought to the market.

- **Dynamism on the buy side**: there are potential buyers who were planning to enter or increase their investment in Spain when the pandemic struck, and who have kept that strategy despite the stand-by period that the market has experienced.

- **Increase in debt servicing capabilities**: there are sufficient servicing capabilities to properly cover the on-boarding and management processes that funds require following the purchase of an NPL or REO portfolio. Servicers are starting to secure value-added structures and instruments (investments in real estate developers, direct lending capabilities, acquisitions of companies specialized in real estate asset management, etc.) which are already allowing them to speed up the return on investments for their customers, funds buying NPLs.

- **Dynamism on the secondary market**: transactions on the secondary market may be expected to continue, via both divestiture of specific portfolios and even of all NPL assets under management in Spain by any of the funds that are completing their investment cycles, which is another element that brings dynamism to the market.

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Mexico

NPLs portfolios and REOs deals: an update at October 2021 in Mexico

1. Market update

According to information reported by the National Securities and Banking Commission (**CNBV**) and in line with the behavior in previous months, as of June 2021, the NPL ratio for the aggregate portfolio of all banks (**IMOR**) was 2.45%, higher than the 2.12% as of June 2020, although lower than the 2.52% reported in May 2021.

The figures reported by the CNBV show that the segments that have the highest NPL ratios in their aggregate portfolio of past-due loans are consumer loans. However, the NPL ratio of the different types of loans included in consumer loans have continued to improve compared with previous months.

Additional information provided by the CNBV shows that the improvement in the IMOR is partially a result of the programs implemented by the Mexican government and the commercial banks, as well as a contraction in the loans granted by commercial banks.

An increase is being seen in the participation of sellers of NPL portfolios on digital platforms, as well as higher numbers of portfolios of this type being offered for sale.

The interest of international players in participating on digital platforms in Mexico for the sale and purchase of NPL portfolios is increasing.

Another trend to note is an increasing number of Fintech companies selling an important volume of NPL portfolios.

2. Key trends

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Peru

NPLs portfolios and REOs deals: an update at October 2021 in Peru

1. Market update

According to the Central Reserve Bank of Peru (BCRP, 2021), the delinquency rate continued to rise, although more slowly than in the previous year. It also reported that a greater number of debtors are resuming their payment obligations, following the gradual opening up of the economy, which, little by little, is reducing the balance of rescheduled loans.

According to the financial stability report published by the BCRP, although the financial system's institutions have reduced their vulnerabilities for the coming months, due to lower exposure to rescheduled loans resulting from the pandemic, it is expected that some institutions, especially the smaller and less diversified, will require additional efforts to strengthen their equity (to be in a better position to face potential impairment losses on their loans).

Rescheduling transactions have prevented rapid impairment of their loan portfolios. As has happened in other countries, the Peruvian authorities have introduced regulatory mechanisms for rescheduling transactions. As a result of rescheduling, delinquency indicators have been stable and have given financial institutions some room for maneuver to absorb the impact of the recession. However, the banks booked provisions, voluntarily mainly, to cover the expected increase in delinquency. This, together with lower lending activity and a smaller net interest income, has reduced the profitability of the financial system, with Peru being one of the countries that showed a rapid and greater decline in profitability indexes due to the strict lockdown measures in relation to its peers in the region.

An important event in this new period was the publication on September 17, 2021 of the regulations on the financing of SMEs through factoring. This, according to many experts in the field, will accelerate and encourage the granting of approval to invoices, which is expected to trigger a greater number of factoring transactions. At the same time, increased competition in the market will allow interest rates to remain stable, despite the increase in the risk premium due to political uncertainty in the Peruvian market.

2. Key trends

We believe that, in this final part of 2021, the publication of the new regulations on factoring transactions for SMEs will be an interesting catalyst for the dynamism in the economy that the local market needs.

- **Aligned incentives in factoring schemes**: the legislation in Urgency Decree 013-2020 (initially announced for the end of 2020) will contribute to kick-starting factoring transactions. It provides, for example, that approval of an invoice - express or tacit - by the payer must be given within eight calendar days, no longer in eight business days. The issuer's approval of an invoice is a requirement for the recipient to be able to advance payment of the invoice in exchange for interest.

- **New players in factoring mechanisms**: the new legislation also includes the fee bills of independent professionals. About 2.5 million independent workers issue fee bills. These types of bills may also be negotiated with factoring companies to collect payment in advance. This will allow diversification in the types of underlying assets for the portfolios to be traded in the future.

- **Multiple types of companies involved in receivable-backed deals**: public utility sector entities continue to play a leading role in these types of transactions, by transferring income streams or collection rights in certain portfolios for the purpose of obtaining immediate liquidity.

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Portugal

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1. Market update

Other than in relation to specific sectors (believed to be those hardest hit by the COVID-19 pandemic), the forbearance program approved by the Portuguese government in March 2020 applicable to loans and similar borrowing transactions conducted by Portuguese financial institutions was lifted on September 30, 2021. At the end of August 2021, €36.3 billion in loan/borrowing transactions were still benefiting from the forbearance regime, €21.5 billion of which relate to funds borrowed by non-financial corporate entities.

There is still widespread uncertainty as to what impact the end of the forbearance regime will have on the economy as a whole and on Portuguese banks' balance sheets in particular. The general view is that the number of sub-performing and non-performing loans will rise in the last quarter of 2021 and 2022 and, consequently, the asset quality of Portuguese banks' balance sheets will deteriorate. The Portuguese government is expecting that the European NextGen funds to be used in the context of the Portuguese Recovery and Resilience Facility will soften the blow. The first tranche of funds (in the amount of €2.2 billion) to be allocated to Portugal was paid out in early August, but specific programs and rules for private sector support and capitalization have not yet been implemented.

Although NPL ratios of the Portuguese banks have been in steady decline in 2020 and the first two quarters of 2021 - currently at 4,3% (second quarter of 2021), down from 5,6% last year (second quarter of 2020) (*source: Banco de Portugal*) - the continued efforts of banks to bring NPL portfolios to the market may not be sufficient to outweigh the expected increase in defaults. After a slow start to the second quarter, new NPL and REO sale processes were launched at the end of the second quarter and into the third, which have continued to garner interest from international investors, with new players also trying to get a foothold in the Portuguese market. This is good news for the main Portuguese banks because the new competitors in the sale processes may help to bridge the bid-ask pricing gap that has impacted some transactions.

2. Key trends

- **Lease agreements on mortgaged properties**: important case law has recently been delivered by the Portuguese higher court, the Portuguese Supreme Court of Justice (*Supremo Tribunal de Justiça*) which may have an impact on the pricing of secured NPL portfolios.

  The Supreme Court of Justice ("**SCJ**") delivered a "standardization" ruling[1] establishing that the judicial sale of a mortgaged property which is encumbered by a lease agreement entered into after arrangement of a mortgage does not trigger the termination of that lease, meaning that the lease will remain in force following the judicial award of the property to the bidder in the sale process. This SCJ decision departs from most of the SCJ's earlier decisions on this

[1] A standardization ruling (*acordãos de uniformização de jurisprudência*) is a type of ruling made by the SCJ which is aimed at unifying different interpretations adopted by Portuguese higher courts on the same subject matter.

subject. The fact of it being a standardization ruling increases its potential impact, because lower courts will be required to abide by this view. Albeit restricted to insolvency proceedings, it is expected that the view adopted by the SCJ will also increase the number of disputes in the context of enforcement proceedings for the judicial sale of mortgaged properties.

- **Secondary NPL/REO market**: secondary market deals have been flowing to the market, both in terms of NPL single-names and NPL/REO portfolios. These have proven to be attractive to investors looking to build up their existing portfolios or sector-specific investors, while also offering an opportunity to the original investor to cash in on certain positions that they consider not to be strategic or in which the workout could prove not to be as beneficial as an outright secondary market sale.

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