GARRIGUES

NPLs portfolios and REOs deals: an update at March 2021

LatAm & Iberia – NPLs Task Force (1T 2021)

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Debt markets continue to feel the calming — even sedative — effects of the battery of support measures rolled out to counteract the decline in business activity due to the effects of COVID-19. Jumbo deals involving non-performing loans (NPLs) are expected to resume in the last quarter of 2021. Until then, we will witness two very interesting developments until then: single name sales and the appearance of new players in the debt market.

Jumbo NPL portfolio deals

There is a certain consensus among NPL portfolio sellers and purchasers that jumbo deals will only return to the scene at the end of 2021. There are three reasons behind the current standstill:

1. The sedative effects caused by State support measures, such as payment holidays, extraordinary capital injections, secured loans, participating loans, the underwriting of bonds and occasional acquisitions of shares, are keeping companies from defaulting on a massive scale. Defaults are expected to impact the balance sheets of financial institutions primarily in 2022, when all of these mechanisms expire or when it becomes harder to qualify for them.

2. During 2021, a large number of hard-hit companies will make use of restructuring measures that will be more or less intense based on the objectives they wish to attain (a new debt structure, a new capital structure, the divestment of non-strategic lines of business or concentration through classic M&A transactions, such as mergers or acquisitions). Portfolio sellers are carefully analyzing how such restructuring efforts could impact the recovery ratio for NPLs in their portfolios and assessing the ideal moment to package them into portfolios and sell them to investors. The aim would be to avoid the transaction and reputation costs associated with restructuring and to obtain a price for the NPLs that allows the accounting provisions to be recovered.

3. Finally, regulators have received a clear message from financial institutions: “we need to make capital requirements for NPLs more flexible”. It is highly likely that regulators will allow financial institutions to record lower accounting provisions for the loans affected by restructuring measures enacted in response to **COVID-19**. This flexibility in capital requirements will allow financial institutions to drain their balance sheets of NPLs in a more structured manner, gradually and over a longer period, with the benefit of lower internal consumption of capital. This will help bring about more uniform portfolios, perhaps even sector-based ones (hotels and tourism, travel agencies, passenger transportation, leisure and restaurants, etc.), because the intensity of the crisis caused by **COVID-19** varies for different sectors.

Single name sales

Until jumbo deals reappear, the trend seems to be for one-off NPL transactions with very specific and rather well-known counterparties (borrower and guarantors), referred to as single name deals. Financial institutions may initiate these types of deals without having to lay out the preparation costs required for jumbo portfolio sales. Furthermore, and due to the characteristics of the borrower or its guarantors, there are fewer purchasers of single names, which avoids lengthy bidding processes that generally have cumbersome purchase agreement and loan documentation requirements.

In the current scenario, the objective is for a single name deal between the originating financial institution and an investor to take place without the transferred loans losing institutional guarantees or State support measures.

Appearance of new players in the debt market

The parties we advise in the debt market also seem to agree that 2021 is a transitional year, the calm before the storm. The storm might not be quick and ravaging (i.e., large NPL portfolios concentrated in a few deals within a short time frame), but instead be more of a steady drizzle over several years.

While we wait to know what the NPL deal weather forecast will look like for sure, we are witnessing the appearance of new players in the debt market. New platforms are appearing for managing non-performing assets (NPLs and foreclosed property or REOs), driven by the financial institutions themselves in their effort to reduce the cost of managing their assets and to provide services to external parties located beyond their usual jurisdictions (Brazil, Mexico). The debt servicing industry is starting to carefully analyze the changes that the forthcoming European Directive on credit purchasers and credit servicers, which is in an advanced legislative state, may trigger.

Latest trends

What trends may already be observed in the main markets in Latin America, Spain and Portugal? What investments will be made in those jurisdictions and who will be behind them?

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 Brazil, Chile, Colombia, Spain, Peru and Portugal.

NPLs portfolios and REOs deals:
an update at March 2021

Brazil

NPLs portfolios and REOs deals: an update at November 2020 in Brazil*

**contents created by Brazilian law firm NBF|A*

1. Market update

The economic crisis caused by the **COVID-19** pandemic will surely cause a significant increase in the levels of financial indebtedness by individuals and legal entities and, consequently, in the opportunities for operations with NPLs.

However, the real effects of the crisis on distressed loans available for negotiation are still difficult to estimate, due to official government aid to the most vulnerable population, as well as the postponements granted to borrowers by both public and private banks. Added to this are uncertainties regarding the pace of the country's economic recovery once the health crisis is minimally overcome.

Faced with this scenario, the first reaction of the NPL market in Brazil has been a paralysis. Indeed, in an environment of serious economic deterioration, it is natural that the parties prefer to wait for the overcoming of the most critical phase of the crisis in order to analyze its real effects on the pricing of assets. However, as the situation normalizes and the different market players have greater visibility on the economic recovery process, the NPL market is expected to re-activate significantly throughout 2021, and still with more intensity in 2022.

It is estimated that, in 2020, bad debt portfolios worth approximately USD 3.6 billion have been negotiated in Brazil. By 2021, according to Deloitte estimates, the pandemic will have contributed to doubling the amount of bad loans available for trading, with the volume of NPLs traded reaching an approximate figure of USD 8.3 billion.

Likewise, it is expected that from 2021 the NPLs market will gain traction with the entry of new players, both national and foreign, interested in taking advantage of the situation resulting from the crisis. There is also the expectation of the return to the NPL market of some banks that had not acted for years, as is the case of the public bank Caixa Económica Federal, which has announced its decision to return to the NPL market after having overcome the effects of an injunction that had suspended its participation since 2016.

Finally, it is worth highlighting the inclusion of *Empresa Gestora de Ativos S.A.* (EMGEA) – a public company in charge of the management and recovery of federal government assets, including bad loans previously owned by certain public banks – in the national privatization program, a project that apparently caught the attention of relevant players in the NPL market.

2. Key trends

- The adverse economic effects of the COVID-19 crisis, once its most critical phase has passed, tend to foster the market for distressed deals in general, and for NPLs in particular.

- The entry of new players in the Brazilian NPL market, as well as the return of banks that was not operating in recent years – as is the case of Caixa Económica Federal – tends to foster market growth from 2021.

- The recent approval of the reform to the Brazilian Bankruptcy Law – associated with other legislative initiatives in the same direction – will have positive effects on the distressed asstes market, by increasing the companies' recovery alternatives and bringing greater legal certainty to the market.

- The strong devaluation of the Brazilian Real throughout 2020, as well as interest rates at historically low levels in Brazil, favors the alternative investment market such as NPLs, as well as the participation of foreign investors in this market.

- Service providers in the NPLs market have been investing in technology with a view to improve the pricing of assets and recovery of credits, which contributes to the sophistication of this market.

NPLs portfolios and REOs deals:
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Chile

NPLs portfolios and REOs deals: an update at November 2020 in Chile

1. Market update

As of January 2021, Chilean banks had an average default rate of 90 days or more, of 1.55% with respect to its loan portfolio, with 1.68% in the corporate sector and 1.37% in the retail sector (consumption and housing), while the total average as of March 2020 was 2.05%.

This low default is partly explained because of the monetary stimulus created by the possibility for individuals to withdraw up to 20% of their pension funds, which many took advantage of to pay debts, in credits with state guarantee for small and medium-sized companies and in credit facilities for banks at zero real rate by the Central Bank.

Chile hopes that its successful vaccination against **COVID-19** will allow “herd” immunity from June 2021 onwards, which could imply the gradual withdrawal of the state injection of resources and at the same time a recovery of economic activity. If the recovery is lower than expected, the unemployment rate may not decrease as expected and the number of failing companies would increase.

These factors will stimulate the sale of NPLs and securitizations to face a potential deterioration of the banks' books and allow them to release provisions.

2. Key trends

- As of January 2021, the Chilean banking system had a low average default rate of 90 days or more, of 1.55% with respect to its loan portfolio. However, this could be temporary and may increase once the implemented monetary stimulus because of **COVID-19** are withdrawn.
- These factors will be an incentive for both sales of NPLs and securitizations in order to face a **potential deterioration of the banks' books**, hence allowing them to release provisions.
- Among the loans that may be transferred, those with a **state guarantee for small and medium-sized companies** will be attractive.
- So far **no active participation of foreign funds as purchasers of NPLs** has been observed, partly due to the withholding tax applicable to loan interest payments and to the exchange risk of loans originated in local currency.

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Spain

NPLs portfolios and REOs deals: an update at November 2020 in Spain

1. Market update

The latest default analyses conclude that the Spanish financial sector's impaired loan ratio will peak in 2022, within an estimated range of 6.5%-8% (FitchRatings). The spike in default next year will depend on when support measures expire and on the degree of containment of distressed borrowers, which are expected to decline over the course of 2021.

In terms of these support measures, in 2020, the rating agency DBRS already noted its growing concern about the adverse effects of loan forbearance, since although it initially benefits borrowers, once the payment holiday period has ended, borrowers' financial situation may be irreversible.

2. Key trends

2.1 The latest in securitizations

European institutions are in the final stages of approving rules amending the current EU Securitisation Regulation and the Capital Requirements Regulation (CRR) for credit institutions. The aim of these reforms is to encourage the securitization of non-performing exposures (NPEs) as a more efficient alternative compared to traditional bilateral portfolio transactions.

We expect that these measures will facilitate both NPE portfolio sales by originating credit institutions (through their bilateral sale or directly through securitization by those institutions) as well as their subsequent securitization by the funds or other institutional investors acquiring those portfolios.

Specifically, when a securitization transaction is 90% supported by NPEs (which have now been defined in the regulation, which contains a catalogue of these types of exposures), the following will occur:

(i) **New parties responsible for retaining the securitization risk**: until now, the original lenders, the originators and the securitization sponsors were required to retain a material net economic interest in the securitization (5%), associated with the portfolio risk. Under the proposed changes, the designated servicer of the securitization will be allowed to take on the risk retention slice, which will let financial institutions fully assign, through securitization, the NPE portfolio to an external party without the original lender having to retain any amount on its books (until now it had to retain the risk without any option to sell or reduce it through hedges).

(ii) **New formula for calculating the securitization risk**: The risk to be retained will no longer be calculated on the basis of the nominal value of the securitized NPEs, but rather a discounted price will now be used. Any fee that the servicer receives will also have to be deducted from that discounted price.

(iii) **New prudential treatment for credit institution investments in NPE securitizations**

(iv) **"Originate to securitize"**: In order to prevent an excessive transfer of risks to securitization investors, originators are currently required to apply the same granting, administration and risk criteria to the exposures that they intend to securitize as they apply to the rest of the exposures on their balance sheets. Aware of the difficulties in complying with this risk control policy, the new regulation allows the owners of previously acquired NPEs, which they now wish to securitize, to deviate from such criteria. However, the credit institutions originating the NPEs will continue to be required to comply with this risk control rule when they assign those exposures to a securitization vehicle.

2.2 New developments in the debt servicing industry

On January 14, 2021, the European Parliament published a report on the proposal for a **Directive on credit servicers, credit purchasers and the recovery of collateral** (the "Directive"). Things are therefore gathering speed and, after the slowdown in 2020, we could potentially have a new regulation in 2021, as we suggested a few months ago.

These links provide access to the Spanish and English versions of the report. The changes made by the European Parliament to the European Commission's initial version appear in bold and italics.

During the first weeks of 2021, Garrigues presented its conclusions on the Directive to the main servicers that operate in Spain and carry out their recovery activities in other European countries as well. The three conclusions presented were as follows:

1. The new proposed Directive has more than sufficient capacity to quickly change the dynamics of NPL or REO purchase agreement negotiations, as well as servicing loan agreements (SLAs).

2. The new proposed Directive will impact the Spanish and European debt servicing industry.

3. Some of the latest changes introduced in the proposed Directive will not further the development of the secondary NPL market. Two examples of this are the statements regarding non-performing exposures that originators must avoid transferring and the requirements for notifying borrowers once the delinquent loan has been sold.

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Peru

NPLs portfolios and REOs deals: an update at November 2020 in Peru

1. Market update

The new pandemic containment measures imposed by the Peruvian government continue to affect employment, as well as companies' sales, diminishing their payment streams. Specifically, consumer loans rose from a default rate of 3.41% in March 2020 to 5.79% in November 2020, being those directly affected by the economic crisis.

Similarly, even though there has not been a significant variation in the default rates of business loans classified by economic sector, according to the *Instituto de Economía y Desarrollo Empresarial* of the Lima Chamber of Commerce, the agricultural sector shows the highest default rate among industries, even though it decreased from 9.0% to 7.9%. Construction, another sector with high default rates, also diminished from 8.4% to 6.4%. However, sectors that have seen their defaulted portfolios rise are electricity and water, from 0.1% to 4.6%.

Notwithstanding the above, the Peruvian government continues to encourage financial institutions to participate in guarantee programs it has created. For example, the **COVID-19** Guarantee Program is aimed at guaranteeing certain rescheduled consumer, personal, housing mortgage, vehicle, and small and medium-size enterprise (MSE) loans, whether from individuals or MSEs, subject to interest rate reductions, waiver of installments, or both, by financial institutions. Coverage for these loans ranges between 40% and 80% for consumer loans, while coverage for MSE, vehicle and mortgage loans typically ranges between 50% and 80%. The tenor for these guarantee ranges between 6 and 36 months, depending on the type of loan, and is usually capped at S/250 thousand for mortgage loans (approximately US$69,400).

As of January 2021 there were 22 financial institutions authorized to submit their loan portfolios to COFIDE, the Peruvian Development Bank (which is the entity that channels the Government's guarantee), and as of such date there were 6 institutions in the process of applying to the program.

Finally, even though these measures have been accompanied by regulation that seeks to reschedule loans, there have been several challenges for rescheduling these types of loans. These include encouraging digitalization, simplifying documentation and increasing maximum loan amounts.

2. Key trends

Although the Peruvian economy has been facing a recession scenario, the marker has continued to develop different ways to promote new financing alternatives backed by loan portfolios, which include not only transactions with impaired receivables but also performing loans.

(i) ***Securitization structures***: Although we believe that this financing alternative has not been fully exploited in the local market, during 2020 several large corporates used it to maximize its benefit as a non-recourse financing to the originator of the receivable. Thus, these structures have the advantage of being flexible to accommodate the context of each company and at the same time robust enough to meet the requirements of potential investors (even those investors with high regulatory standards). In these financings, trusts play a fundamental role in isolating the receivables from the originator's insolvency risk.

(ii) ***Increased access to smaller players***: In Peru, as in other economies with more developed markets, through the promotion and standardization of products trusts have become a more widely used tool for financial structures, not only for companies seeking to raise large amounts of debt, but also for smaller companies. The entry into the market of medium-sized trustees has reduced the costs of creating and maintaining trusts, allowing them to be more widely used in the market. Various local securitization companies have introduced standardized products to obtain financing for amounts starting as low as US$100,000.

(iii) ***Multiple types of companies involved in receivable-backed deals***: Another interesting trend worth highlighting is the entry of public utility companies into the receivable-backed financing market. These types of entities have been closing deals whereby that have transferred cash flows or receivables from certain portfolio pools for the purpose of obtaining short-term liquidity.

(iv) ***Limited Due Diligence****:* Having also mentioned the entry of new players in the local market, we have seen that recently due diligence requirements from arrangers has become much more limited, basically focusing on aspects directly related to the receivable being collateralized and not on the originator's entire business. Depending on the type of securitized asset, it is very common for due diligence to be performed only on significant samples from a pool of receivables.

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NPLs portfolios and REOs deals:
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Portugal

NPLs portfolios and REOs deals: an update at November 2020 in Portugal

1. Market update

NPL markets in Portugal remain mature and highly palatable for investors. Notwithstanding some early concerns arising from execution risk, transactions that came to market were (or are excepted to be) successfully closed.

The "usual suspects" have continued to show interest in the NPL portfolios being offered by Portuguese banks, with some new players "popping up" for specific portfolios. Millennium bcp (Projects Ellis and Webb) and Novo Banco (Projects Carter and Wilkinson) were the main players on the sell-side with each successfully placing two portfolios in the market.

In the last quarter of 2020, the Government approved extraordinary measures in relation to the recovery of companies suffering financial hardship or insolvency in the context of the **COVID-19** pandemic, one of which was the creation of a new extraordinary business viability process (*procedimento extraordinário de viabilização de empresas* - PEVE), which, upon appointment of a judicial administrator, leads to a standstill applicable to debt recovery proceedings, affording the debtors some level of protection against its creditors.

Due to the rise of **COVID-19** cases, Portugal went into a new lockdown in the first quarter 2021, and with it came the reinstatement of some of the measures that had been established in March/April 2020, in particular the suspension of non-urgent proceedings which will of course have an impact on workout timings.

More importantly, the new lockdown and other extraordinary measures will surely have an impact for the majority of businesses which were already struggling. Businesses were nevertheless also given some relief measures, for instance borrowers were allowed to adhere to the forbearance regime again in January 2021 (the previous period for adherence had ended in September 2020). Nonetheless, the forbearance periods have not changed and will come to an end as early as 31 March 2021 (in respect of interest payments) and 30 September 2021, generally. The possibility of the forbearance periods being extended is being discussed, in particular in respect of the sectors which have been more affected by the pandemic.

In terms of NPL transactions, after a slow start to 2021 in terms of new deals, new organized sales procedures are expected to emerge as early as March/April.

2. Key trends

(i) ***Potential increase of NPL ratios***: due to the forbearance regime still being in force, there is still a widespread concern that the end of the moratorium will increase NPL ratios significantly in the final quarter of 2021 (possibly two times the current ratio, which is at present already almost double the average of EU-Member States). As a result, deal volume is expected to be high in the coming months of 2021 in order to minimize impact of such NPL ratio increase.

(ii) ***Restructured loans***: restructured loans are a common feature in corporate portfolios, but are usually non-performing. A recent trend has been the inclusion of restructured loans which are still performing. In addition, such restructured loans are sometimes covered by the **COVID-19** forbearance regime which would remain applicable when transferred to the investors. The inclusion of restructured performing loans has a relevant impact on workout strategies and in pricing, in particular considering that most investors interested in these portfolios are Loan-to-Own investors.

(iii) ***Stability of portfolios***: one current concern is the stability of the portfolios initially being placed on the market compared to what is effectively being sold at closing, i.e. that the positions (and/or certain debtors) being offered at the beginning of the process remain the same at closing. This is not so much a factor in granular portfolios, but considering that most of the current portfolios that are being placed are in respect of corporate debtors and of a less granular nature, the exclusion of certain positions may have a very relevant impact in the offers being made and in the expectation of prospective investors, in particular if this occurs after the binding offers have been submitted.

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