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NPLs portfolios and REOs deals: an update at March 2022

LatAm & Iberia – NPLs Task Force (1T 2022)

March 2022

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NPL transactions continued in the first quarter of 2022. Spain and Portugal were the most active jurisdictions with our Madrid, Barcelona and Lisbon offices playing a leading role.

The growing pace of transactions in southern Europe has coincided with the lifting and phasing out of debtor support and relief measures adopted in response to the COVID-19 pandemic.

We have witnessed the appearance of NPL portfolios with higher aggregate values and made out a very clear interest in securitizations of both NPLs and the rights associated with REOs. European debt servicers are starting to take positions in the transposition process of the European Directive on credit purchasers and credit servicers, in force since December 28, 2021.

Increase in aggregate values of NPL portfolios

In the first quarter of 2022, we identified In Spain and Portugal a clear trend among financial institutions towards designing NPL portfolios with higher aggregate values. Although they have not yet reached the proportions of the jumbo portfolios we were seeing before the pandemic, it does clearly seem that for NPL portfolios sold in competitive bidding processes, sellers consider that economies of scale justify greater aggregate values.

Phasing out of debtor relief and support measures

Although debtor support measures in response to the pandemic are coming to an end, a few do still apply in debt transactions. In Spain, for example, suspension of the debtor's duty to petition for an insolvency order has been extended until and including June 30, 2022. Petitions for insolvency orders filed by creditors since March 14, 2020 have also been suspended until the same date.

Greater interest in securitization structures

Sellers of NPLs have confirmed their interest in securitization structures. Alongside traditional securitization transactions (those involving performing loans), sales of distressed loans and assets are starting to gain market share, as are synthetic transactions, in which the bank keeps the loan or asset on its balance sheet, and transfers cash flows and a large part of the risk of the investment to investors. The largest securitization process of this type in Europe was Project Galaxy (€10 billion) featuring the Greek Alpha Bank.

New European directive on credit purchasers and credit servicers

Towards the end of 2021, Directive (EU) 2021/2167 of 24 November 2021 on credit servicers and credit purchasers and amending Directives 2008/48 and 2014/17 was published.

The goal of the new directive is to propel activity on secondary markets for NPLs and it has sufficient potential to change dynamics in the debt servicing industry. The directive also creates a new map of strengths, weaknesses, opportunities and threats for transactions with NPLs which operators will benefit by knowing. In the transition period, now in progress and ending on December 29, 2023, the main players in the NPL market (sellers, purchases and servicers) should analyze their internal processes in depth. There are important changes on the horizon for the main NPL servicers and purchasers, which will affect their domestic and international transactions.

The new directive is designed to reach all participants in the NPL market: servicers, purchasers and sellers of NPLs.

NPL servicers will have to obtain authorization to carry on their activities and will have to come under the supervision of a national authority in each member state. NPL purchasers will have to review their agreements with servicers and take on board the “reasonable forbearance” principle: the forbearance they have to show before initiating foreclosure proceedings against certain borrowers, which includes a list of forbearance measures.

Lastly, when financial institutions sell NPLs they will have to share information on those loans with their purchasers which is to be done using templates (known as EBA data templates). The directive defines strict timeframes for mandatory use of the EBA data templates by seller credit institutions in transactions with NPLs. Use of these templates to supply information to the purchaser will be mandatory for NPLs which were arranged later than July 1, 2018 and became non-performing loans before the directive came into force (December 28, 2022). Until the EBA’s technical standards on these templates come into effect, however (they have to be submitted to the Commission within 9 months from the directive’s entry into force), the EBA templates only have to be completed with the information that the selling credit institution has available.

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 March 2022 in Colombia

1. Market update

According to the Colombian supervisor's (SFC) report, at the 2021 year-end NPL transactions showed signs of continuing at a brisk pace after slowing down slightly in mid 2021, associated primarily with the base effect of 2020 and a lower default rate. In real annual terms, the NPL portfolio had grown by 4.3% at December 2021, which was higher than the figure recorded a year earlier in 2020 (2%). Another important element is that following the end of the debtor support measures adopted in the pandemic, the uptick in the economy in the second half of 2021 brought delinquency indicators to pre-March 2020 levels.

The SFC's report notes that at the 2021 year-end, the balance of loans in the country's portfolio that were more than 30 days past due amounted to COP 22.7 billion (peso/euro exchange rate $4,527), falling by 17.6% in real annual terms against a contraction in NPLs in all loan types. The decreases were 16.4% in commercial loans; 25.2%, in consumer loans; 0.5%, in residential loans; and 2.8%, in microloans.

The NPL ratio (ratio of non-performing loans to total loans) was 3.9% for the aggregate loan portfolio. By type, the reported rate for microloans was 6.6%, followed by consumer loans at 4.4%, commercial loans which ended the year at 3.7%, and residential loans, at 3.3%. The dynamics of provisions reflected more stable conditions for debtors after the shock effect of the pandemic.

The report highlights that the main portfolio segments with balances under the PAD loan forbearance program (*Programa de Acompañamiento a Deudores*) adopted in the pandemic are free investment, credit cards and revolving credit cards, and small and medium-sized businesses.

Despite a lower NLP ratio than in 2020, the NPL sales market has kept up its pace and remained dynamic. Despite banks' efforts to normalize their portfolios, coupled with a range of debtor support measures, there is a segment of customers who were unable to resolve their debt issues, which has created a space for investors interested in those portfolios. One of the country's main NPL portfolio servicers recorded investments made by Deva Capital and another investor, in two separate transactions, amounting to roughly USD 25 million.

Lastly, Law 2157 was published in 2021, containing "right to be forgotten" data protection legislation which, among its provisions, sets out certain rules for reporting adverse information to credit bureaus.

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Spain

NPLs portfolios and REOs deals: an update at March 2022 in Spain

1. Market update

2021 ended with a rally of new NPL portfolio transactions in Spain.

One of the largest was concluded by KKR which bought from CaixaBank a portfolio of 3,500 unpaid mortgages. The face value of the transaction (€580 million) and the sizes of the funds that competed for the assets until the end (KKR, Tilden Park and Waterfall) made it one of the year's most prominent transactions. Caixabank had also just concluded a sale to Cabot and Hoist of unsecured loans to small and medium-sized businesses and consumer loans (€400 million, "Pompidou" project).

Also towards the end of 2021, BBVA initiated another transaction for a similar amount (€500 million, "Minolta" project) involving mostly unsecured loans. Banco Santander launched another divestment of NPLs (€600 million, "Titán" project), bought by Tilden Park, after beating bids by Bain Capital, Fortress, Cerberus and Byview.

Before the 2021 accounting year-end, Bankinter transferred to Zolva an NPL portfolio without collateral coming from Bankinter Consumer Finance (€100 million, "Drakkar" project). The portfolio consisted in the main of consumer loans and revolving credit card debts. Bankinter has therefore joined the ranks of banks packaging up these NPLs to transfer them on the secondary market, faced with the risks of defaults multiplying among SMEs and households that turned to borrowing under the strains caused by the COVID-19 pandemic.

The end of the year also saw the completion of transactions "Cacao" and "Oroel". In both cases, the buyer was an alliance between investors Metric and Albatris.

Now, in the third quarter of 2022, attention in the market has turned to Banco Santander and its reperforming loan transaction (€700 million, "Macondo" project). Sales of loans of this type which are not NPLs in form although they equally penalize financial institutions because they have to record provisions even though the loans have been renegotiated, could become an interesting trend.

2020 also had an interesting start for CaixaBank (€300 - €400 milion, "Guggenheim" project), which launched a corporate NPL portfolio, and KutxaBank, which started preparing a new transaction, focused on secured NPLs ("Nuevo Lezama" project)

2. Key trends

- **Jumbo transactions side by side with very small transactions, this second type generally in bilateral processes**: the last quarter of 2021 and first quarter of 2022 confirmed financial institutions' preference for offering a mix of products to investors. Alongside jumbo transactions – launched on the market in competitive bidding processes –, there has been a repetition of transactions with very small amounts – focused on positions in very specific debts or assets, with one or two natural buyers –. This is how sellers ensure the placement of NPLs, and increase their recovery rate.

- **Study by sellers of alternative divestment structures such as securitization funds**: where NPLs are transferred to a securitization fund, the originator (seller) stays on as lender of record and the securitization fund is the beneficiary of receivables arising from the transferred NPLs.

Investors in securitization funds, who have to meet a number of characteristics, subscribe to the securities in securitization funds and by doing so indirectly acquire a position in the transferred NPL portfolio. Because securitization funds are separate sets of assets which by law cannot have any rights and obligations other than the transferred NPL portfolio itself, investors are able to have proper control over their exposures to securitization funds. Also, the legal rules on securitization funds significantly lower the risk of insolvency, a feature that is bringing increased interest in securitization processes for NPL portfolios.

- **Growing interest in setting up funds to invest in single names transactions:** the now confirmed trend among Spanish financial institutions – and foreign funds selling their NPL positions on the secondary market - towards selling their NPL exposures bilaterally and in single name transactions has brought new players to the market (debt funds). The unrestricted capital of these new funds is amply above €100 million and their goal is to conclude multiple transactions bilaterally which will enable them to build up portfolios of uniform NPLs, linked to specific sectors of activity.

- **Keeping up the pace of transactions on the secondary market**: whereas transactions featuring financial institutions have stayed leisurely, transactions on the secondary market have been brisker, prompted by the decisions of a few debt funds to reduce their exposures to the Spanish debt market.

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Mexico

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1. Market update

According to information reported by the National Securities and Banking Commission (CNBV) based on performance in 2021, non-performing loans in the largest three bank lending segments (business, consumer and mortgage) at the end of 2021, had fallen compared with 2020.

Data reported by the CNBV show that aggregate non-performing loans in 2021 amounted to 4.48% of the total balance outstanding, which is a 0.72 decrease compared with the 5.20% figure recorded in 2020.

Within the range of bank loan types in Mexico, it may be observed that: (i) in 2021 loans to households recorded a 12.17% adjusted NPL ratio (down by 2.27 percentage points year on year); (ii) the ratio was 14.55% for credit card debt in 2021 (down by 3.14 percentage points year on year); (iii) 15.96%, for personal loans in 2021 (down by 2.31 year on year); (iv) 9.37% for business and government lending (down by 0.14 percentage points); and (v) 3.95% in mortgage lending (down by 0.34 percentage points).

The improved performance of NPL figures in bank lending is largely explained by a contraction in the commercial bank loan portfolio.

2. Key trends

- **Digital platforms and NPLs**: we are still seeing greater numbers of sellers of NPL portfolios using digital platforms, as well as a greater offering of those portfolios.

- **Fintech**: numbers of fintech businesses continued to rise, these business sell large numbers of NPL portfolios.

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Peru

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1. Market update

According to the Central Reserve Bank of Peru (BCRP, 2021), in the third quarter of 2021, the NPL ratio stabilized at around 6.2%. The growth of the non-performing loan portfolio was retained in most lending segments. However, since the beginning of the third quarter of 2021, rising numbers of defaults were observed in the portfolio of debts of medium-sized businesses.

Late payments mainly related to medium-sized businesses that had rescheduled loans and obtained loans from large banks and some larger non-bank entities. By economic sector, these companies operate in the trade, services and manufacturing sectors.

However, according to the financial stability report published by the BCRP, given the deterioration in the quality of these loans, financial institutions have modified their lending criteria, to apply more conservative client selection policies. Although, from one angle, this has favored credit risk management, it has also had an effect on the decrease in loans to medium-sized businesses. In a scenario of slower economic growth or a slower than expected recovery, the payment capacity of these companies could deteriorate, which could affect institutions with a greater exposure to this lending segment.

A positive aspect highlighted in the report is that the SME NPL portfolio showed a favorable decrease, as a consequence of the gradual recovery of the economy in the first half of the year 2021. This has reduced the provisioning requirements of non-banking entities, thereby favoring their profitability ratios.

Against this backdrop, other financing mechanisms for SMEs and medium-sized businesses will gain importance, such as access to fintechs engaged in lending or factoring (to obtain immediate liquidity).

Thus, on the one hand, NPL portfolios have been reduced in certain segments, which in turn has led to greater profitability for financial institutions; while, on the other hand, it could be argued that new NPL portfolios could migrate to those fintechs that are engaged providing loans with their own funds. This second aspect may undoubtedly accelerate securitization transactions, as we will describe below.

Likewise, it is important to highlight that last August 20, 2021, SBS Resolution No. 02429-2021 was published, approving the rules on the temporary performance of activities in novel models was approved. The purpose is to provide rules on the temporary performance of novel models (business or operating models that imply the performance of activities in a different way from the traditional way used by companies, requiring pilot tests, regulatory flexibility or regulatory modifications). This legislation came into force on February 1, 2022. It will be interesting to see the impact of these rules in terms of NPL portfolio management, policies or similar aspects that may be implemented by traditional financial institutions.

2. Key trends

- **More active secondary loan market:** One of the mechanisms being used by traditional financial institutions is to divest part of their interests in the loans in which they are involved, so that they can reduce their exposure to credit risk.

- **New financing alternatives:** Changes in the lending criteria of traditional banking players, through the application of more conservative client selection policies, are driving the continued rise of fintechs in the lending segment.

- **Securitization structures to finance fintechs:** In line with the comments in section 2 above, fintechs, with their performing portfolios, are participating in various structures that involve the transfer of their main assets to trusts or similar structures. In turn, in order to avoid an increase in their NPL ratios, fintechs are beginning to incorporate into their structures collection services using non-traditional mechanisms.

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Portugal

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1. Market update

As a result of the forbearance rules coming to an end in September 2021, many had foreseen rising insolvencies and default rates in the last quarter of 2021 and 2022. Nonetheless, thus far we have not witnessed an important increase in loan default rates, although there are still concerns that this may occur in the current year. Inflation and a probable interest rate increase may also play a part in the coming months.

Several legislation packages were enacted at the beginning of 2022, which may have an impact on the non-performing loans market.

- On the one hand, amendments have been approved to the Portuguese Insolvency Code with the purpose of increasing efficiency in restructuring and insolvency proceedings (implementing Directive 2019/1013, of 20 June 2019) – these amendments may have a positive impact on the servicing of NPL portfolios allowing for swifter collections for investors and/or approval of restructuring plans;

- On the other hand, pursuant to Decree-Law no. 11/2022, of January 12, 2022, the Portuguese government approved a set of rules on “participative” loans, which will give Portuguese companies access to additional funding in the form of loans classified as equity for accounting purposes and as subordinated claims for insolvency purposes (payable after unsubordinated creditors and before shareholders). This new type of loan is expected to be used frequently in the context of Portuguese companies accessing funds from the Portuguese Recovery and Resilience Plan (most of which originate from the EU NextGen). Ultimately, this will provide additional liquidity to Portuguese companies and will generally assist businesses affected by COVID and in need of capital for new investments in addition assisting them in keeping default on existing indebtedness at bay.

As in past years, the NPL market was very active in the last quarter of 2021, with the major Portuguese banks marketing several portfolios in order to deleverage their books before closing the financial year. Several new investors are showing interest in the Portuguese NPL market and some of them have been rewarded by finding themselves the winning bidder. The success of these new players may have a positive effect of drawing further attention from additional new investors.

2. Key trends

- **Decreasing aggregate OB of NPL portfolios**: From 2017 onwards there was a clear strategy by several Portuguese banks to consolidate NPL positions and package them in large portfolios before placing them on the market. By way of example, Project Atlantic (CGD), Nata I and Nata II (Novo Banco) all had aggregate outstanding balances in excess of €800 million (with Nata II originally surpassing €3 billion). Even in 2020, there were still several portfolios exceeding €500 million. Although it is expected that there are still large unsecured portfolios to be placed on the Portuguese market in 2022, secured portfolios to be marketed are expected to have a lower aggregate OB - a strategy that may result in attracting a higher number investors (with lower investment tickets), but is also the result of the decrease in the NPL ratio on the books of Portuguese banks.

- **Stability of NPL portfolios**: one area where there is still room for improvement is portfolio composition stability, in particular after submission of binding bids by investors. There have been several cases in the Portuguese market where NPL positions are excluded from the scope at a later stage of the transaction. This has proven to be highly frustrating for certain investors, in particular in non-granular portfolios, where investors have carried out a full due diligence and valuation of those NPL positions, and, as a result, incurred significant costs and a considerable amount of time in the analysis of such positions. This sentiment may impact cost coverage provisions which banks may need to accommodate if there is an effective risk that material positions are excluded from the sales procedure.

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