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Debt portfolio (NPL) and toxic asset (REO) transactions

Update at November 2023

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In the first three quarters of 2023, we saw investors adopting a more selective and specialized approach in their NPL investments, increasing their appetite for unlikely-to-pay (UTP) and reperforming loans (RPLs).

Other market niches that are catching investors' attention have been prompted by the worldwide fall in commercial real estate prices, as well as new opportunities in residential real estate owned (REO) properties and single-name loans (defaulted loans to individual borrowers).

The financial situation and political tensions in a few Latin American countries are compelling financial institutions to study ways to speed up their deleveraging. It is key for investors to know what types of assets are going to come to market, who are the main sellers and local purchasers and what infrastructure of advisors, local partners and intermediaries exists in the country.

In Europe, the final data templates to be used by financial institutions selling NPLs to provide information to purchasers have now been published. The templates have been in effect since October 19, 2023, although the European directive imposing their use has yet to be transposed in all member states (Spain and Portugal are about to do so).

Global NPL ratio figures in 2022

According to the latest data published by the World Bank (2022), among the jurisdictions we cover in this publication, Peru in 2022 had the highest ratio of nonperforming loans to total gross loans (4.1%), followed by Spain (3.1%), Colombia (2.5%) and Mexico (2.1%). The World Bank has not published the indicators for Chile and Portugal.

Signs of credit deterioration and increase in nonperforming loans in Europe

According to Eurostat there are indications of deterioration in loan assets, mainly related to the number of bankruptcies in the European Union. This number rose considerably in the fourth quarter of 2022 (+26.8% compared with the previous quarter). In annual terms (Q2022-Q2021), the number of bankruptcies increased in the transport and storage sectors (+72.2%); accommodation and food services (+39.4%) and education, health and social activities (+29.5%). Alongside this, high inflation is also contributing to a deterioration of credit. The most recent models (June 2023), based on forecasts drawn up from data published by the International Monetary Fund, confirm that a sustained inflation rate may increase NPL ratios substantially even without entailing a severe recession.

Increase in corporate transactions in the servicers' sector

In Spain in particular we are seeing a considerable amount of activity around servicers. Following the sale, in March 2023, of Finsolutia, servicer to British fund Pollen Street, in May 2023, Intrum completed the purchase of all the capital of Haya Real Estate, creating a team of more than 2,000 professionals managing over 200,000 real estate assets and €60 billion million in debt under management. Before summer 2023, KKR closed a mandate for the sale of its servicer Hipoges, for an indicative price of €200 million, which has not yet been completed. At the beginning of September

2023 it was released that Lone Star had also put its servicer Servihabitat up for sale, with the intention of selling off the whole company. It recently came to light that Silver Lake is interested in selling its servicer Lexer (acquired in 2021 for €150 million).

New EBA data templates for the sale of nonperforming loans

Directive (EU) 2021/2167 of 24 November 2021 on credit servicers and credit purchasers set out an obligation for financial institutions selling nonperforming loans to use templates (the EBA data templates).

The use of EBA data templates to provide information to purchasers will be mandatory for overdue loans that were originated on or after July 1, 2018 and became nonperforming before December 28, 2022.

In December 2022, the European Banking Authority (EBA) published its draft Implementing Technical Standards (ITS) on NPL transaction data templates. Recently, on September 26, 2023, the ITS were published in the Official Journal of the European Union. The final templates, in effect since October 19, 2023, include 129 data fields, of which 69 are mandatory for sellers.

Some analysts (NPL Markets) have commented that transferring data to the new templates is relatively straightforward using existing technology, although financial institutions are expected to find it challenging to provide all mandatory data fields immediately to purchasers.

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

Debt portfolio (NPL) and toxic asset (REO) transactions in Chile

1. Market update

Amendment of the Insolvency and Recovery Law

In May 2023, amendments coming into effect in August were made to the Insolvency and Recovery Law, designed to enhance a few components of this law, which in 2014 replaced the bankruptcy law in force since 1981.

A few of the main amendments are described below:

- The insolvency protection period has been extended from the previously in force 90-day period to 180 days. The reason is that in complex reorganization processes the negotiation periods for a reorganization agreement were very tight.
- If the debtor gives rise to claims in the insolvency protection period, these claims will have priority for payment not only if the reorganization the debtor proposes to its creditors is rejected (the consequence of which is liquidation of the company) but also where liquidation is ordered.
- The judge is allowed to render a decision on voluntary liquidation of the debtor company, even where there are no outstanding proceedings against the applicant.
- To apply for the liquidation of a debtor company due to the existence of a past-due enforceable instrument against the company, that instrument will have to come from the operations or business activities of the debtor company. It therefore restricts widespread use of the liquidation process as a debt collection method.
- On the discharge of debts, after the liquidation process has ended, it provides - among other rules - that full or partial discharge will not be allowed for debtors declared to be acting in bad faith. Additionally, debtor discharge does not include personal guarantees or security interests.
- Bad faith is considered to exist if the debtor files false or incomplete information on its circumstances, hides or destroys information or assets or rights in the two years preceding the liquidation process, if the debtor commits bankruptcy related offenses or if clawback actions are ordered against it.
- Insolvency proceedings on small or medium-sized companies and on the debtor have been simplified.

2. Key trends

The Chilean central bank opens a comment period on the Retained Securitization Standard

The Central Bank of Chile recently opened a comment period on a standard for retained securitization or “self-securitization”, whereby a banking institution may acquire from securitization companies (which may be the bank’s own subsidiaries) debt securities having loans arranged by the banking institution itself as their underlying assets.

If implemented, the aim of this proposal is to allow securitized instruments acquired by banking institutions to be used as collateral in transactions that the banking institution concludes with the central bank or with other institutions, to gain access to credit facilities, for example.

It is useful to recall the types of portfolios that banking institutions may sell to securitization companies and the procedure for that sale:

1. Banking legislation and regulations allow certain assets in banks’ portfolios to be sold or assigned to securitization companies: (a) letters of credit issued by the bank itself or third financial institutions; (b) endorsable or non-endorsable mortgages, issued by the bank itself or other financial institutions, excluding letter of credit mortgages under Title XIII of the General Banks Law; (c) assets in its consumer loans portfolio; (d) assets in its commercial loans portfolio; (e) finance lease agreements; (f) certain types of financial investments consisting of certificates issued by Banco Central de Chile; (g) other financial investments they are allowed to acquire under the General Banks Law or other special laws; and (h) discounted prices from the sale of real estate received to pay off overdue debts or acquired in court auctions of real estate sold for the same reason.

2. All these assets must fulfill specific requirements, such as having to be owned by the banking institutions and in certain cases, paid for in installments.

3. Banking institutions cannot repurchase assets that have been sold to a securitization company or mutual fund. This is the most important restriction for securitization transactions performed by banking institutions.

The Retained Securitization Standard proposed by the Chilean central bank only allows retained securitization in relation to endorsable mortgages. It may be carried out, subject to certain requirements, with securitization companies that are subsidiaries of the bank concerned. If the same bank acquires the whole of a securitized bond issue, the bonds will have to be valued by reputed companies that do not have any ownership or management ties with the bank acquiring a retained securitized portfolio. Moreover, for these bonds to be able to be provided as collateral to the central bank, they will have to have an AA or higher local risk classification.

Now that the comment period has ended, the Central Bank is expected to issue this legislation shortly.

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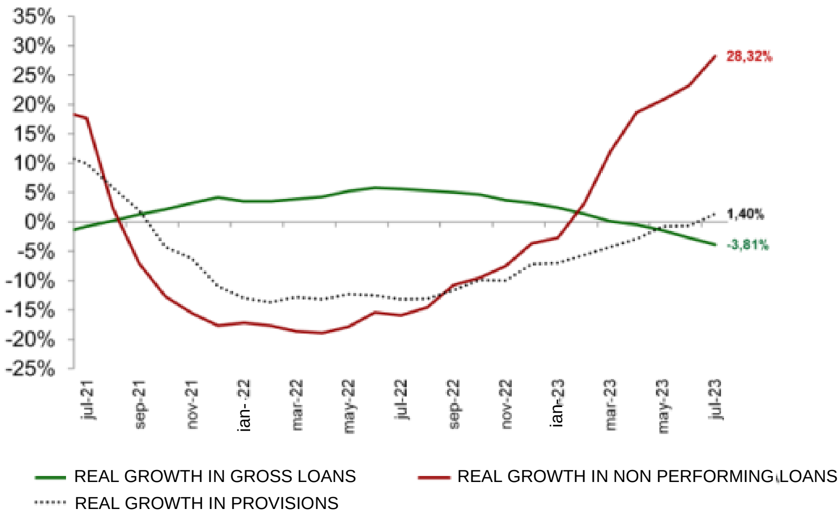
Debt portfolio (NPL) and toxic asset (REO) transactions in Colombia

1. Market update

The most recent report by Superintendencia Financiera de Colombia (SFC), the Colombian financial supervisor, as of July 2023, provides the following account of the performance of the financial system's NPL portfolio:

> *"Gross loans amounted to $680b (…). In line with the credit cycle, for the fourth month running gross loans experienced negative growth year-on-year, equal to -3.82%. This reflects: (i) the greater negative annual real annual growth in consumer (-7.05%), commercial (-2.71%) and home loans (-1.71%), which could not be offset by the increase in microloans; (ii) the decrease in the month-on-month figure (-$2b, $9.5b lower than the month-on-month figure reported in the same month in 2022); (iii) the dynamics of disbursements to households and businesses which reached $33.5b; (iv) the adjustment for the effect of inflation as a result of nominal growth rate being higher (7.5%) than the real increase; and (v) the dynamics of write-offs which in July amounted to $1.4b, equal to the figure reported in the same month in 2022. It is worth noting that 87% of total loan write-offs relate to consumer loans, and 7%, to commercial loans.*
>
> *(…)*
>
> *The balance reported to be overdue by more than 30 days amounted to $33.4b. This amount has stayed at the same level and home loans were the only category that recorded negative growth. A $1.2b month-on-month increase in the overdue balance was reported. In particular, compared with the same period in 2022, this figure grew in real annual terms by 28.3%, driven by late payments on consumer loans which grew by 46.6% in real annual terms, microloans which recorded 25.8% year-on-year, in positive figures for the fourth month running, and commercial loans which reported 18.8%. In contrast, home loans reported -0.55%.*
>
> *Performing loans amounted to $646.6b, accounting for 95.1% of the total amount. In relation to the PAD debtor assistance program (Programa de Acompañamiento a Deudores), 80.6% of the amount remaining under the program relates to performing loans. It is worth remembering that the amount in the PAD has fallen to $13.3b, in other words 2% of total loans. In a breakdown by category of loans covered by the program, 85% of consumer loans are performing, followed by commercial loans (79.4%), home loans (73%) and microloans (72%).*
>
> *The quality indicator for loans as a whole, namely the NPL ratio (ratio of nonperforming loans to gross loans) was 4.9%. The slight increase in the indicator was due to a combination of effects, including: (i) an increase in nonperforming loans in all loan categories except for home loans and (ii) a decrease in the denominator due to a lower gross loans figure. By category, consumer loans reported a 7.5% ratio, followed by microloans which stood at 7.4%, commercial loans, at 3.8%, and home loans, at 2.9%"*



Source: Superintendencia Financiera de Colombia (SFC). Financial System Update, July 2023 (*Informe de Actualidad del Sistema Financiero, julio 2023*).

2. Key trends

1. **Faster pace of deterioration in consumer loans**: in a recent presentation to the debt collection association forum, the SFC spoke about credit trends. The published figures for December 2022 show a faster pace of deterioration in consumer loans, which is related to the worsening situation of households.

2. **NPL sales and the supervisor's view**: the SFC has expressed the view that NPL sales provide a valid tool for dealing with defaulted payments, although it does not dilute institutions' responsibility to financial product consumers, because it does not terminate the relationship with those consumers in the long term.

3. **Consumer loan sales**: credit institutions are currently actively selling NPLs, especially consumer loans. According to the available figures for December 2022, NPL sales amounted to $330 billion.

4. **Precautions by sellers of NPLs**: in view of the increasing supply of NPLs and the resulting price adjustment, some institutions take them off their balance sheets, although it is becoming increasingly more common to transfer them to special purpose vehicles, for one reason to avoid disposing of them at low prices, and for another, to attempt to keep customers in their own ecosystem, for the purpose of handling the normalization process under their own policies and attempting to bring the greatest number of customers back to their banking services to retain their custom.

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Debt portfolio (NPL) and toxic asset (REO) transactions in Mexico

1. Market update

According to information reported by the National Securities and Banking Commission (CNBV), in June 2023 the NPL ratio for total bank loans was 2.18%, lower than the 2.32% figure recorded in June 2022. The figures reported by the CNBV show that the segments of total nonperforming loans with the highest NPL ratios are consumer loans (3.07%), home loans (2.60%) and commercial loans (1.74%).

Some financial analysts have described an upward trend in lending (consumer loans mainly, which increased by approximately 12%) and commented that nonperforming multiple banking loans have stayed at relatively low levels. Growth in lending was the highest in the past 10 years.

Growth in credit card loans was 16.8% (the biggest rise in 15 years), 11.1%, in payday loans, 7.4%, in personal loans, and 107%, in loans for lasting consumer goods.

Estimates of the annual value of NPL transactions in Mexico range between 80 million and 100 million dollars. Because of this they are not currently attracting many international funds, which are used to handling these figures in a single transaction

2. Key trends

1. **Constant flow of NPL transactions**: a constant flow of NPL sales has been observed, which is expected to continue in 2023. The main sellers continue to be BBVA México, Banco Santander and Banorte.

2. **Local players**: Mexico is still in the sights of local participants in the NPL industry, which continue to play a very active role through various structures to finance the acquisitions they make.

3. **Looking at 2024**: investors will continue expecting an increase in the number and volume of nonperforming loans arising from bankruptcies of international financial institutions and companies. That increase has yet to be seen.

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Debt portfolio (NPL) and toxic asset (REO) transactions in Peru

1. Market update

In May 2023, the Central Reserve Bank of Peru highlighted the measures implemented by financial institutions to control the deterioration of the portfolio of loans to medium-sized companies, which was reflected in a reduction of the delinquent loans in that segment in 2023. However, the NPL ratio for loans to medium-sized companies has increased due to the deceleration of loans to these types of companies, given the more conservative criteria for the selection of debtors. In addition, loan rescheduling allowed us to mitigate the negative effects of the social conflict and climate factors on delinquency. However, this was offset by the slight growth of nonperforming loans to consumers and small businesses, which naturally should generate an increase in the NPL portfolios that could be sold in the market by financial institutions.

On the other hand, an important aspect to highlight in transactions in Peru is the use of factoring as a favorable trend in the last two years.

The Lima Stock Exchange (BVL) through Cavali (Peruvian clearing and settlement institution), informed that as of June 2023, factoring has enabled financing through negotiable invoices amounting to S/17,276 million (approximately €4,330 million), 35% above the figure for the same period in 2022.

Cavali pointed out that 725,053 of electronic invoices were electronically recorded on Factrack, 27% more than in the first half of 2022. It is worth mentioning that in May 2023 a record 132,836 invoices were recorded, surpassing the 130,468 recorded in December 2022.

Cavali reported that in the first six months of 2023 15,279 supplier companies have also benefited nationwide, most of which are SMEs that find in factoring a fast and effective financing alternative for their commercial campaigns.

2. Key trends

1. **New financing alternatives**: changes in the lending criteria of traditional banking players, through the application of more conservative customer selection policies, are driving the continued growth of fintechs in the lending segment and the growth of other segments such as payments.

2. **Loan sale and securitization structures**: new structures are appearing involving sales of invoices with recourse against the assignor, where recourse against the assigned debtors is triggered when the original assignor defaults on payment. Other structures being implemented in the Peruvian market are venture debt financings for lending and leasing fintechs, through securitization of end-customer receivables consisting of online loans and vehicle leases.

3. **Sustainability criteria in financing**: undoubtedly one of the most visible trends in the past two years is the application of sustainable financing in its various meanings. This implies that, in creative and innovative ways, ESG criteria are being incorporated into the financing

mechanisms used (i.e. reduction of fees upon compliance with certain objectives, use of specific resources to meet one of the Sustainable Development Goals). For their part, funders seek to create and participate in structures that have this component. This trend is also applicable to financing mechanisms such as factoring.

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Debt portfolio (NPL) and toxic asset (REO) transactions in Portugal

1. Market update

Although, generally speaking Portuguese banks have continued to pursue certain deleveraging objectives, the market has been relatively quiet during Q1 and Q2, in particular when comparing it to pre-pandemic levels.

Investor interest seems to remain strong in respect of all asset classes, but until Q3 the size of portfolios being traded has been significantly reduced. Up to Q3 the typical aggregate outstanding balance being transferred ranged between €100 million and €150 million (Project Crow, a REO portfolio of around €850 million in value was an exception).

The portfolios of nonperforming loans that have come to market in 2022 and 2023 have all been mid-sized (within the range mentioned above) and for the most part tend to be corporate loans, with a mix of both secured and unsecured loans. However, second half of 2023 has seen the arrival on the market of NPL portfolios of aggregate size with relevant volume and a highly diversified asset class (granular and corporate credits, secured and unsecured), which are attracting a lot of interest from international investors.

With regard to new sales processes for 2024, it is important to note that SMEs are still benefiting, to some extent, from COVID-19 financial support schemes. Some of these support schemes may be reaching maturity in 2024, which, combined with high interest rates and inflation, may lead to additional defaults and restructuring of non or sub-performing loans taken out by SMEs, as well as pressure from the Bank of Portugal for a greater deleveraging of Portuguese financial institutions take place.

One topic that continues to be an issue in bank-originated portfolio sales processes is the increase in delinquencies, particularly in larger portfolio processes. Investors are demanding that the speed and efficiency of lender’s led processes be increased to prevent delinquencies from impacting on portfolio recovery.

2. Key trends

1. **NPL portfolio size**: despite the larger portfolios already on the market, it is expected that the majority of portfolios coming to market in 2024 will be small or medium-sized. This being the case, the profile of investors looking to acquire the portfolios may not change substantially as investors typically having bigger tickets could be looking to book-build on portfolios already acquired in the past year.

2. **Increased use of securitization structures**: greater use of these structures by investors is starting to be identified in NPL transactions in Portugal.

3. **Insolvency law amendments**: post-pandemic changes to Portuguese insolvency law have had positive impacts on collections, timing of proceedings and servicing of loans in general (in particular, on corporate loans).

4. **Impact of rising interest rates**: high interest rates may create additional pressure on NPL investors who leveraged the acquisition of portfolios in the past, thereby increasing secondary market opportunities in respect of certain assets. Speedier collections may, however, counterbalance the effect and provide liquidity for investors to comply with debt service obligations.

5. **Appetite for single-name loans**: although there is investor interest in single-name positions, transaction certainty, execution risk and timing are deterring factors.

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Debt portfolio (NPL) and toxic asset (REO) transactions in Spain

1. Market update

According to figures published by the Bank of Spain, in 2022 and the first quarters of 2023 a sharp decline in the outstanding balance of ICO transactions was observed (program of government guarantees for loans to non-financial companies introduced by ICO, Spain's official credit institute, in response to the start of the COVID-19 pandemic). This figure fell from €95 billion to €73 billion (figure as of March 2023) and was explained by the repayment made through ordinary payments or full discharges by borrowers that did not consider the funds would be needed. However, although the drawn-down amount for credit facilities to companies secured by an ICO guarantee was lower, their credit quality also dropped. At the end of June 2023 - latest available figures -, the declared damaged debt figure amounted to €2,815 million (total value of ICO loans with outstanding payments plus write-offs suffered by the ICO in restructuring processes or insolvency proceedings).

According to the latest Financial Stability Report published by the Bank of Spain (spring 2023), in 2022 nonperforming assets continued to fall and at a faster rate than in previous years (-18.5%). This was seen in the NPL ratio, which dropped significantly both for households (0.9 pp) and nonfinancial corporations (NFCs) and sole proprietors (0.7 pp). Stage 2 (i.e. significant credit risk since initial recognition, but no event of default), forborne and restructured loans also fell (-12.2% year-on-year).

Real estate owned assets (REO) decreased by 14.5% in 2022, to stand at €19.7 billion in December. This was a continuation of the declining trend seen in recent years in which these exposures have fallen by more than €11 billion (36%).

According to figures in the latest monthly statistical bulletin published by the Bank of Spain, in August 2023 doubtful loans amounted to €42,100 billion, which placed the ratio of bank nonperforming loans to total gross loans at 3.56% (0.9% more than in the previous month).

Financial institutions are continuing attempts to reduce toxic loans and assets figures by selling loans to funds. Various calculations show that in 2022 institutions transferred €11 billion. Among these transactions were Proyecto Austro (OB 832 million, Banco Sabadell-Zolva), Proyecto Neila (OB 730 million, BBVA), Proyecto Vector (OB 307 million, Unicaja-Axactor) and Proyecto Cora (OB 300 million, Banco Sabadell).

In 2023 the pace of NPL transactions quickened, and there was even a jumbo transaction. The most prominent NPL transactions were Proyecto Nairobi (OB 500 million, BBVA-Kruk & Cerberus); Proyecto Victoria (OB 3 billion, Sareb-Axactor); Proyecto Spirit (OB 1.1 billion, Banco Santander-Cerberus & Axactor); Proyecto Nébula (OB 2 billion, Blackstone); Proyecto Valhalla (OB 1.6 billion, Deutsche Bank) and Proyecto Sunshine (OB 6 billion, Axactor).

Transactions with REOs notably included Proyecto Vision (OB 215 million, Coral Homes/Lone Star), involving 286 assets, of which 247 were land and 39 were structures that were in progress or on which construction work had stopped.

2. Key trends

1. **The decline in NPL sales in 2022 triggered interesting reactions by sellers**: sellers have focused on and devoted resources to developing mechanisms for converting NPLs into re-performing transactions, by stepping up amicable management of late payments where recovery problems are caused by dysfunctions in the judicial system (in particular, the strike by justice system lawyers between January and March 2023).

2. **A number of regulatory changes may have a significant impact on the NPL sector**: the new provisions on debt restructuring using preinsolvency tools (restructuring plans) and the transposition of the European directive on credit sellers, credit purchasers and credit servicers (the EU Servicers Directive) may contribute to changing the pricing mechanisms for NPLs (by increasing the value of any debts that may impose a restructuring plan) and moving forward the concentration process - now in progress - of Spanish credit servicers.

3. **The most conservative forecasts do not point to a significant increase in the NPL ratio or volume**: operators are currently directing efforts at keeping NPLs under control through active management of outstanding payments through rescheduling as the preferred solution, to repayment even.

4. **There are a few factors which could change this conservative forecast**: 50% of existing nonperforming loans are corporate loans (half of these, loans to developers), whereas the remaining 50% are personal loans (half of these are unsecured); a continued increase in interest rates may, in the medium term, have effects on the increase in total nonperforming loans. For example, 60% of mortgages have yet to be repriced as a result of the staggered increase in interest rates, which could cause a wave of mortgage portfolios (secured NPLs), although a few analysts consider that those transactions may take a while to crystallize due to the legal requirements relating to the maturity of mortgage transactions in arrears (between 12 and 15 months to accelerate the loan).[1]

5. **Sales of subperforming and unsecured loans as portfolios or single-name transactions:** certain types of investors have identified these as extremely profitable transactions and are promoting them among financial institutions. These transactions are challenging for financial institutions to manage because they require a fresh cash injection - which financial institutions are prevented by regulatory issues from providing -, and this naturally causes them to move out of the internal circuit towards investors. Investors able to understand the underlying business will be in better conditions to standardize or industrialize this type of transactions and make them widespread like NPL sales.[2]

[1] Estrada, A., Bank of Spain, Recent trends in Spanish Banking Sector (Spanish NPL Market Overview, NPL Days Spain 2023, June 2023, DD Talks)

[2] Estrada, A., Bank of Spain, Recent trends in Spanish Banking Sector (Spanish NPL Market Overview, NPL Days Spain 2023, June 2023, DD Talks)

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