BEST PRACTICES FOR FINANCIAL INSTITUTIONS FACING CHALLENGES IN EFFECTIVELY AND EFFICIENTLY MANAGING NON-PERFORMING LOANS

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ALVAREZ & MARSAL

INTRODUCTION

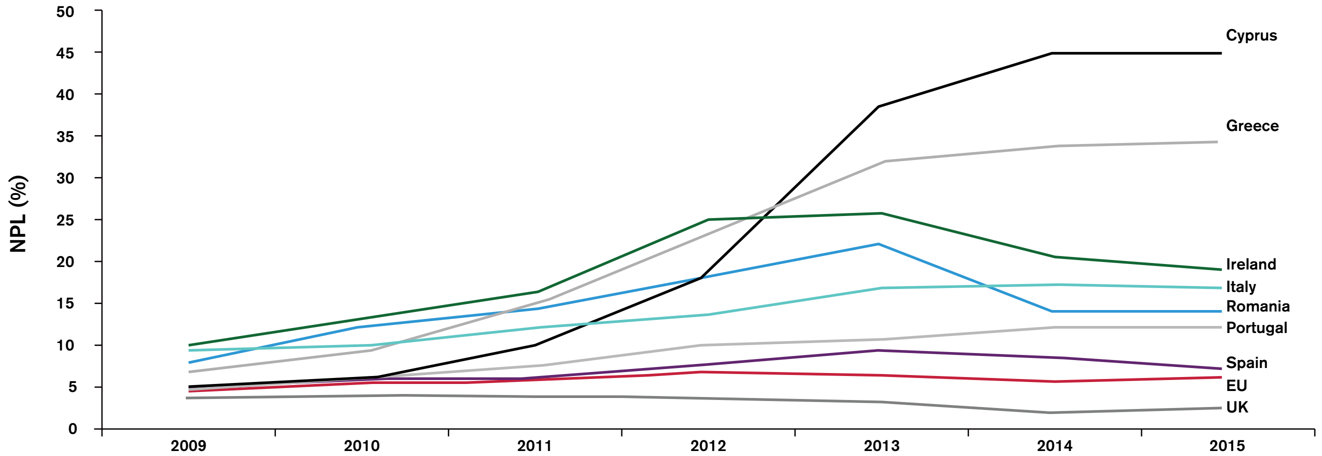
Non-performing loans (NPLs) have increased significantly across Europe since 2008, mainly due to poor supervision and governance, aggressive lending and acquisition strategies, loose credit underwriting policies, high exposure to sectors that were most impacted by the financial crisis (such as real estate) and lax credit controls. The situation has worsened with the prolonged economic downturn pushing highly leveraged borrowers into financial difficulties and leading to a large number of defaults. Increased regulatory requirements for NPL management (including the European Central Bank (ECB) Asset Quality Reviews, harmonisation of NPL classification and disclosures, and the introduction of specific NPL codes and directives) have also contributed to the increase in the overall NPL pool in Europe.

According to the International Monetary Fund (IMF) Euro Area Policies July 2015 Issue, NPLs have reached c.€1 trillion, more than double the amount in 2009, highlighting that the issue remains a challenge across the European banking sector. The volume of NPLs is particularly significant in South Eastern and Central Eastern Europe where NPL ratios as a percentage of gross loans are in double digits, far exceeding the European Union averages.

A high volume of NPLs causes a significant drag on a bank's performance in the form of:

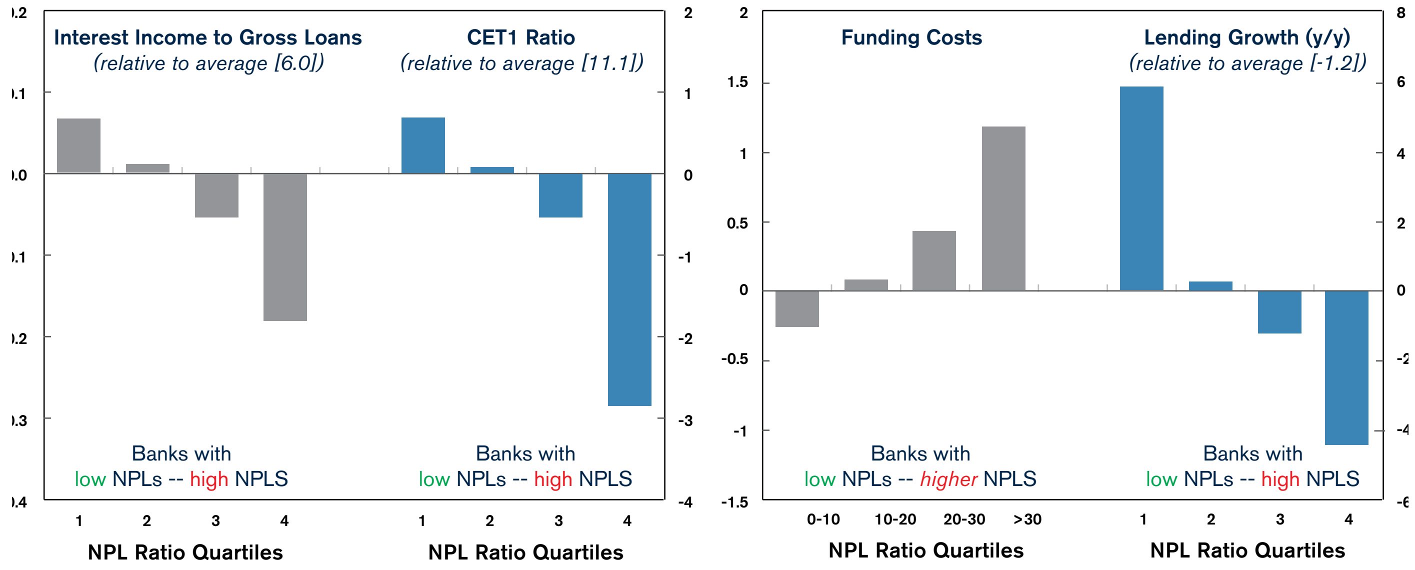
- reduction in ***net interest income;***
- increase in ***impairments costs;***
- additional ***capital requirement*** for high-risk weighted assets;
- lower ratings and increased ***cost of funding,*** adversely affecting ***equity valuations;***
- reduced risk appetite for ***new lending;*** and
- ***additional management time and servicing costs*** to resolve the problem.

GROSS NPL % OF SELECTED COUNTRIES BETWEEN 2009 AND 2015



Source: World Bank, European Banking Authority and International Monetary Fund

THE IMPLICATION OF HIGH NPLs FOR BANK PERFORMANCE IN EURO AREA



Source: IMF

1. "Interest Income to Gross Loans" chart shows the annual interest income to gross loans, for over 100 euro area banks compared to the annual average for banks with the same nationality, over the period 2009–13.
2. "Funding Costs" chart shows the average funding cost for each bank, which was defined as [interest expenses/(financial liabilities-retail deposits)] compared to the sovereign bond yield (five-year average).
3. "Lending Growth" chart shows annualized lending growth relative to average lending growth in the same country, using data from the European Banking Authority for a sample of more than 60 banks over the period 2010–13. Outliers have been excluded, based on extreme values for lending growth, NPLs and interest margins.

Banks have put significant resources and effort into action in the last few years to deal with their NPLs. These actions comprise:

- aligning their businesses with regulatory requirements such as setting up separate dedicated in-house NPL units;
- identifying, categorising and provisioning NPLs more rigorously;
- standardising and improving work-out, legal enforcement and underwriting processes; and
- developing additional restructuring products.

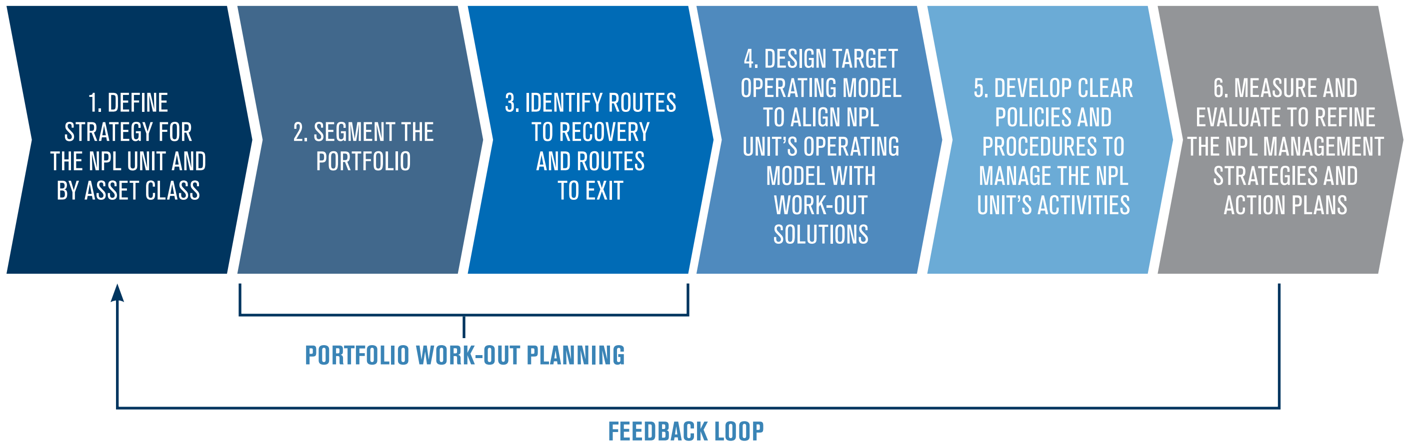
These are major improvements in tackling the NPL problem but a lot more needs to be done in the near future. From a regulatory perspective, NPL management is one of the five key priorities of the Single Supervisory Mechanism (SSM) in 2016, which has established a European-wide taskforce to focus on this matter on a regional basis.

NPL management requires a systematic, proactive and focussed approach. In this paper, based on our extensive experience gained through many global engagements, we summarise best practices for banks to manage both **NPL stock** (in Part I) and **NPL flow** (in Part II) efficiently and effectively.

PART I – ADDRESSING THE NPL STOCK

The best practice for banks in addressing the NPL stock is to develop comprehensive strategic plans detailing how they will deal with NPLs in a systematic way. Asset classes are typically split into two main categories: (i) retail loans – consumer and mortgage loans – and (ii) non-retail loans – mainly commercial real estate, SME and corporate loans. The strategy must be adapted for each asset class and be realistic and achievable by creating sustainable long-term work-out solutions in a capital-efficient and cost-effective manner. Alvarez & Marsal's (A&M) best practice NPL management methodology involves six key steps as follows:

A&M SIX-STEP NPL MANAGEMENT METHODOLOGY



The following section particularly focuses on the second and third steps, namely portfolio work-out planning.

PORTFOLIO WORK-OUT PLANNING

It is critical to have a detailed action plan for the work-out of all material loan positions above a certain threshold, as well as plans at segment or cluster level for the remaining portfolio. Each plan should have up-to-date information indicating key value drivers, risks, milestones, range of recoveries and time to recovery. Action plans should consider each exposure at a relationship level rather than individual loan or borrower level.

Portfolio segmentation – Segmentation involves identifying homogenous loan groups within the portfolio to enable the targeting of efforts and the appropriateness of different types of work-out strategies to preserve the value. The segmentation will be driven by the unique characteristics of the portfolio; however, the list below summarises some of the most common categories based on our experience:

Performance	▪ Performing / sub-performing / non-performing ▪ Restructured / stabilised / sustainable
Loan Type	▪ Unsecured consumer / residential mortgage / SME / corporate / commercial real estate / project finance / private finance initiative / housing association lending
Borrower / Business Characteristics	▪ Individual versus business ▪ If business - active industry or stage of business (start-up, growth, mature) ▪ If individual borrower - age might be an important category to consider ▪ Level of borrower corporation for resolution (low, medium, high)
Collateral Characteristics	▪ Real estate versus other collateral ▪ Real estate characteristics such as LTV, asset type (development, land, industrial, office, retail, residential), whether the asset is income generating or not
Location	▪ Geography of the collateral ▪ Borrower jurisdiction, i.e. country
Investment Requirement	▪ Working capital or capex requirement for the business or the real estate collateral

Once the portfolio is segmented and material individual loan positions are identified, the best practice is to approach the work-out planning as a two-step process by:

i. Identifying Routes to Recovery; and

ii. Identifying Routes to Exit.

Identifying Routes to Recovery – This detailed analysis of the portfolio helps formulate work-out strategies that optimise loan recoveries without accounting for typical time and resource constraints, thereby defining the potential recovery ceiling for the bank. The developed work-out strategies will define expected recovery, potential loss and an expected timeframe to recovery for each material loan position and portfolio segment. Estimates of recovery and timeline need to be realistic and should not aim to justify low provisions. Routes to recovery also act as a back-up plan in case the exit option of selling a loan or portfolio segment does not materialise or is not feasible. This exercise is very critical and needs a highly skilled set of employees and/or external advisors.

Recovery options, expected recoveries, timelines and milestones should be reviewed and revised on a regular basis depending on the complexity and the specific situation of each case.

ROUTES TO RECOVERY

Consensual

- **Restructuring the loan with new terms or collateral;** or restructuring the business with **new lending or equity**
- **Cash settlement via cash generated by the underlying business** (usually performing or sub-performing loans)
- **Cash settlement via the sale of underlying collateral** with borrower's consent
- **Cash settlement via the sale of other assets** or other cash sources of the borrower
- **Repossession** of the real estate or assets securing the loan by borrower's consent
- **Out of court restructurings** (INSOL principles)

Legal

- **Enforcement** of underlying collateral if the borrower is not cooperative
- **Recovery through in-court restructuring schemes**
- **Recovery through insolvency, liquidation, administration** process

Identifying Routes to Exit – Routes to Exit consider Routes to Recovery together with the bank's strategy and constraints (such as capital position) and external factors to determine the ultimate exit strategy. Typical external factors include regulatory requirements, legal impediments, macro-economic conditions, availability of skilled resources, servicing options and investor demand for NPL acquisitions.

ROUTES TO EXIT	
	Work-out strategies: Consensual or legal work-out strategies as detailed in routes to recovery
	Immediate sale: Suitable for unsecured loans or loans with limited potential for an upside through internal work-out strategies
	Hybrid strategy: Work-out of loans with enhancement potential for a specified time followed by a sale
	Structured solution: Such as an SPV. Applicable for complex loans or portfolio segments where new money is needed or bank's involvement plays a key role in improving recoveries

Work-out versus sale – There are key advantages and considerations for both work-out strategies and loan or asset sales as follows:

		ADVANTAGES	CONSIDERATIONS
WORK-OUT	CONSENSUAL	▪ Potential for high recovery and low-cost as lengthy and costly legal process will be eliminated	▪ Skilled staff ▪ Suitable staff incentivisation scheme ▪ Funding requirement of the borrower in the form of new lending or equity ▪ Political ramifications ▪ Time to execution
WORK-OUT	LEGAL	▪ Framework for binding restructuring and recovery ▪ Precedents provide more certainty in more developed markets	▪ Legal costs ▪ Uncertainty around legal outcome, particularly in less developed markets ▪ Time to execution
SALE	SALE - LOAN PORTFOLIO	▪ Frees up management time and reduces operational risks ▪ Improves liquidity position of the bank ▪ Potential to improve capital adequacy ratios ▪ Potential to improve credit ratings	▪ Discount to gross loan value ▪ Adequate provisioning by the bank ▪ Quality of portfolio, which drives price, such as collateral locations, governing jurisdiction, etc.
SALE	SALE - REAL ESTATES OWNED	▪ Opens up a wider investment base that would only be interested in assets but not in loans or borrowers ▪ Removes uncertainty regarding loan servicing	▪ Reputational risk associated with removing any incumbent tenants ▪ Recovery solely depends on real estate value, no other sources ▪ Capex / OPEX requirements
SALE	STRUCTURED SOLUTIONS - E.G. SPV	▪ 3rd party independent execution ▪ Works best for single asset classes	▪ Immediate crystallisation of losses through asset transfer ▪ May not result in deconsolidation of exposure due to regulation ▪ Time to execution - a more complicated structure with several external counterparties and therefore may be more time consuming to implement

Selecting a portfolio for a sale transaction – When executing a sale transaction, selection of the right portfolio is critical. The selection should consider not only internal but also the external factors. Based on our experience, key considerations in identifying the most suitable loans or portfolio segments for a sale transaction are:

i. **Delta between recovery value from a sale and internal work-out ("pricing gap")** – Based on our experience, unsecured loans or loans with limited upside potential through internal work-out are suitable for an immediate sale. Portfolios for which investors are willing to pay a premium can also be considered for a transaction.

   For some loans, it may be better to work out for a certain period with clear milestones and targets before bringing them to the market for sale to optimise recoveries.

   The key to this approach is to have realistic and defendable recovery targets, robust internal work-out strategies and the appropriate level of provisions. One of the main reasons for failed sale transactions in Europe has been the wide bid-ask spread, i.e. the gap in price expectations of investors and banks.

ii. **Bank's strategy and risk appetite** – Portfolios or loans that are not part of the bank's overall strategy or risk appetite can also be considered for sale transactions. In recent years, many European banks offloaded or exited certain loan products (such as shipping loans), highly leveraged sectors (such as real estate lending), or certain geographies that are not considered to be part of their strategy or risk appetite. Reducing non-core or NPL portfolios is also considered to improve the level of transparency and confidence in the robustness of the balance sheets of the banks, which may favourably impact the valuations.

iii. **Operational constraints or cost considerations** – Executing a work-out strategy requires a certain skill-set and infrastructure such as an automated IT system for a consumer portfolio or experienced work-out officers with sectoral, real estate or legal expertise for large corporate and real estate loans. A bank may not have such adequate systems or skilled resources, or the cost-benefit analysis may not justify the investment. Alternatively, the size of the NPL portfolio may be significant compared to the bank's internal capacity or external servicing solutions may be limited in the local market. In such circumstances, selling the assets or loans may be a better option than internal work-out.

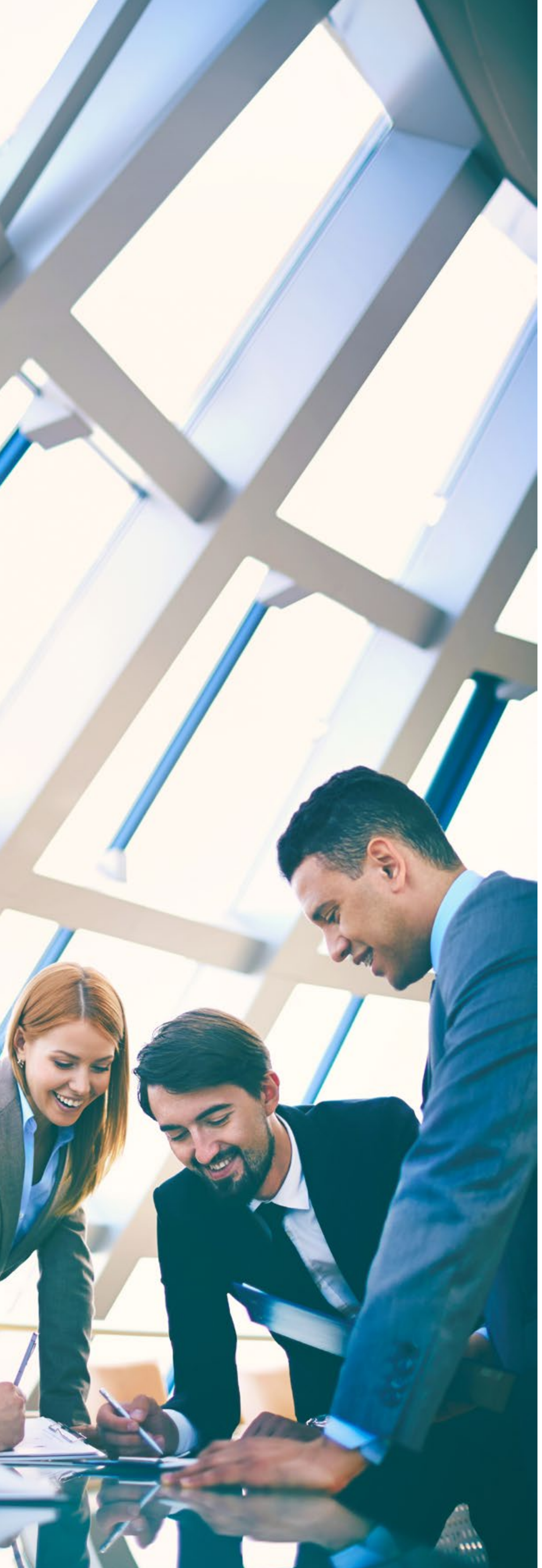
iv. **Market demand** – Willingness to sell is only one component of the equation in a sale transaction. There must also be sufficient demand from investors to acquire those assets or loans. Price is not the only consideration for an investor. Other factors such as stable macro-economic and political environment, ease of doing business, availability of funding, having a credible loan servicing solution, and a solid legal, tax and regulatory regime will also be critical for their decision.

Sale preparation – Preparedness plays a critical role in a sale transaction to attract investors. Due diligence is an expensive process and investors have limited resources. When prioritising their acquisitions, preparedness of the seller for the transaction will be an important consideration.

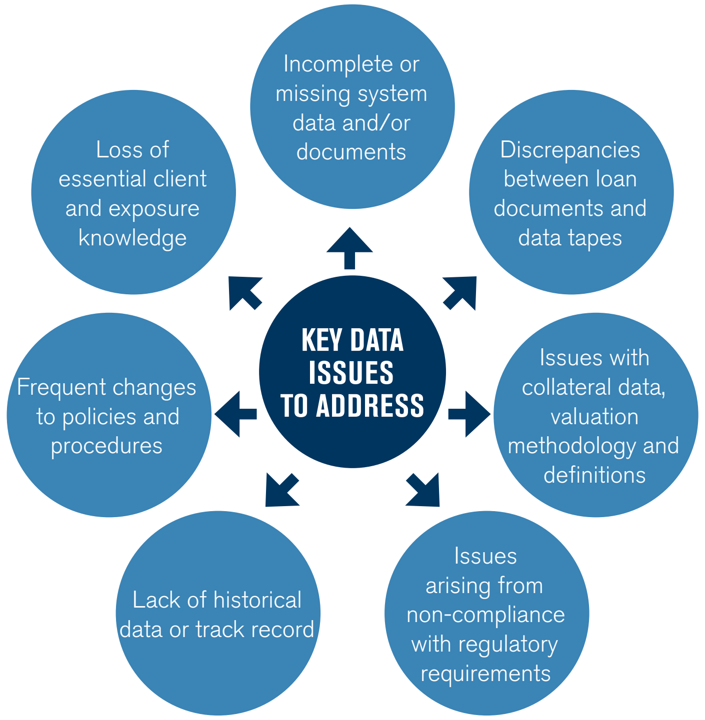
Preparedness also bridges the bid-ask spread by removing uncertainties and unknowns in a potential transaction and gives optionality to the seller in the form of a back-up plan if the sale does not materialise or if alternative deal structures need to be considered. A&M's best practice tips for sale preparedness are:

BEST PRACTICES FOR SALE PREPARATION

- **A robust and credible internal work-out plan** - that will clearly identify portfolio segments and recovery options and that will serve as a back-up plan in case the sale does not go through
- **Understanding investors' motives and requirements** - price is not the only consideration. Other factors such as availability of funding, loan services solution, legal and regulatory requirements and tax implications will also be critical
- **Size of portfolio** - should consider potential investors, complexity of the underlying positions and seller's ability to run an efficient process
- **Market timing** - is critical especially when there are many transactions in progress in the market as investors would have limited resources to allocate and the would prioritise opportunities
- **Data quality** - accurate, complete and up-to-date system and document data is critical. Returns on investments in improving data quality are very high. It also shows the commitment of the seller for a successful transaction
- **Data accuracy** - preform data integrity checks and have internal challenge sessions for completeness and robustness of information that will be disclosed during a sale process
- **Collateral valuations** - make sure valuation of the underlying collaterals is up-to-date and valuation standards meet investors' expectations. Seller's internal policies for collateral valuation may not be suitable for a sale
- **Security perfection** - for loans secured on collateral, the seller must be able to demonstrate that they have proper title for all secured assets



Based on our experience, a seller will need to address the following key data-related issues in order to minimise any value leakages:



PART II – ADDRESSING FLOW OF NEW NPLs

For a sustainable NPL management process, addressing the flow of new NPLs is as important as managing the stock. There are two critical steps in controlling NPL flow: i) developing robust underwriting criteria, policies and procedures; and ii) developing early warning systems.

It is also important that learnings from managing the NPL stock are reflected in underwriting criteria, policies, procedures and in early warning systems. The overall process of NPL management should be iterative and supported by robust feedback loops so that learnings from past experiences are reflected in the process.

Developing robust underwriting criteria, policies and procedures – The flow of new NPLs is controlled by amending the risk appetite and lending underwriting criteria. It is critical to set thresholds and limits around riskier lending including loan-to-value ratios (at an individual exposure and segment level), leverage ratios, sector and geographic limits and product limits. The underwriting criteria needs to be aligned with the economic conditions of the market and should lag (and not lead) the market.

Underwriting criteria, models, policies and procedures and NPL management procedures will need to be continuously reviewed and updated on the basis of actual performance.

Early warning systems – Flow can also be controlled by developing a robust early warning system to identify individual position and risk segments in the portfolio for immediate attention and remediation, with the goal of preventing these loans from converting into NPLs. Effective early warning systems rest on five pillars:

	DESCRIPTION
TOOLS	▪ **Effective early warning signals** to identify risky customers • Including automatic technical triggers (such as overdrafts), external financial triggers (such as EBITDA), and manual expert triggers (such as loss of key employees) • Additional triggers and specific thresholds for specific segments and industries ▪ Potentially **automated generation and calculation** of most signals
MITIGATING ACTIONS	▪ **Predefined set of mandatory actions and strategies** for different watch list categories and segments to mitigate risks early ▪ **Automatic workflow management** between business, underwriting and risk (via early warning tools)
PROCESSES	▪ **Different watch list categories** reflecting different degrees of riskiness of watch list customers ▪ **Early warning systems to be fully embedded in monitoring process,** with clearly defined responsibilities for identification, validation, classification and subsequent proposal and execution of mitigating actions
REPORTING & MONITORING	▪ **Monitoring and reporting of detection effectiveness** ▪ **Tracking and reporting effectiveness of initiated actions** and possible root causes for non-success such as exposure reductions ▪ **Updating of early warning systems** based on ongoing review and validation of signals and processes
ORGANISATION	▪ **Monitoring** as an **independent unit** within credit risk office, with **final decision in classification** of customers **and actions** for watch list customers ▪ **Sufficient staffing** to complete all tasks

PART III – CONCLUSION

- ADDRESSING BOTH EXISTING NPL STOCK AND FLOW OF NEW NPLS IS CRITICAL TO DEVELOPING A SUSTAINABLE NPL MANAGEMENT SOLUTION.
- OUR RECOMMENDED BEST PRACTICE FOR BANKS IN ADDRESSING THE EXISTING NPL STOCK IS TO DEVELOP COMPREHENSIVE STRATEGIC PLANS DETAILING HOW THEY WILL DEAL WITH NPLS IN A SYSTEMATIC WAY FOR ALL MATERIAL LOAN POSITIONS ABOVE A CERTAIN THRESHOLD AND PLANS AT A SEGMENT LEVEL FOR THE REMAINING PORTFOLIO. EACH PLAN SHOULD CLEARLY INDICATE KEY VALUE DRIVERS, RISKS, MILESTONES, RANGE OF RECOVERIES AND TIME TO RECOVERY.
- WORK-OUT PLANNING IS A TWO-STEP PROCESS AND INCLUDES FIRST IDENTIFYING ROUTES TO RECOVERY AND THEN IDENTIFYING ROUTES TO EXIT.
- KEY CONSIDERATIONS FOR SELECTING A LOAN PORTFOLIO FOR A SALE TRANSACTION ARE THE DIFFERENCE BETWEEN RECOVERY VALUE FROM A SALE AND INTERNAL WORK-OUT, THE BANK'S STRATEGY AND RISK APPETITE, WORK-OUT DEPARTMENT'S CAPABILITIES AND CONSTRAINTS, AND INVESTORS' APPETITE FOR ACQUISITION.
- PREPAREDNESS IS CRITICAL IN A SALE TRANSACTION TO ATTRACT INVESTORS AND BRIDGE THE GAP IN PRICE EXPECTATIONS OF INVESTORS AND SELLERS.
- LEARNINGS FROM MANAGING THE NPL STOCK SHOULD BE REFLECTED IN NEW ORIGINATIONS. THE OVERALL PROCESS OF NPL MANAGEMENT IS ITERATIVE, THEREFORE IT NEEDS TO BE SUPPORTED BY ROBUST FEEDBACK LOOPS AND THEN CORRECTIVE ACTION TAKEN, IF REQUIRED.

Tom McAleese
Managing Director
tmcaleese@alvarezandmarsal.com
+ 353 (0) 87 798 4310

Harish Kumar
Managing Director
hkumar@alvarezandmarsal.com
+ 44 (0) 7943 825 609

Deniz Erkoc
Senior Associate
derkoc@alvareznandmarsal.com
+ 44 (0) 7903 087 277

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