

# The growing supply of non-performing loans

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The European market for non-performing loans (NPLs) is expected to increase over the next two to three years, as lenders try to clear up their balance sheets.



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Investors expect a significant number of portfolios to be marketed in Europe within the next 12-24 months – which suggests a ‘buyers’ market’, both in terms of pricing and ‘Sale & Purchase Agreement’ terms. The UK is expected to be particularly active. We estimate the UK NPL market’s size to be between £50bn and £100bn, making it one of the most significant markets globally. Looking at the rest of Europe, Spain is currently attracting a lot of investor attention, with portfolios being offered for sale exceeding €10bn.



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## Key issues in the European NPL market

### Pricing

**Scarcity of debt financing:** Lack of debt financing increases the amount of equity required in order to complete a purchase. This reduction in leverage means that investors are paying lower prices in order to achieve their internal rate of return targets.

**Historical collections:** the past is not necessarily a good guide for the future: Historical collection data currently available reflects the more benign credit conditions of the last decade. In the UK, collection agencies are already reporting an increasing number of borrowers that are unable to sign full and final settlements due to the lack of available financing/refinancing.

**Opportunity cost:** Due to limited resources and the larger number of portfolios being offered for sale across Europe, investors are being more selective about which portfolio sales they participate in and may discount their pricing as a result. Furthermore, availability and experience of existing local due diligence teams, ranging from local lawyers to accountants, is key in determining whether investors are willing to participate in a sale process.



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## Impact of the real estate market decline

Investors are uncertain regarding the extent of property market falls in certain markets (namely the UK and Spain) and are currently discounting prices for secured portfolios more than in the past.



### Due diligence

**Legislation:** European governments are currently under pressure to ensure that foreclosure is the solution of last resort and some of them (for example in the UK) have introduced measures to extend the mortgage repayment periods for certain borrowers. This creates significant uncertainty over the enforceability of loans and the representations and warranties provided by the seller.

**Quality of information:** Investors are requiring more detailed information and larger sampled data as part of their due diligence process because of market uncertainty and the risk-averse nature of their Investment Committees. This means that the seller's preparation and ability to address the investor's concerns will be key in maximising value from the sale.

### Tax

**Withholding taxes:** Withholding tax leakage may arise on certain proceeds from the debt collection. In particular the interest withholding tax position needs to be secured as part of the repayment of the loans may be considered interest for tax purposes. In practice, treaty-based structures may mitigate the withholding tax risk, provided sufficient substance is maintained and beneficial ownership issues are properly addressed.

**VAT:** The VAT upon the sale/acquisition of the portfolio needs to be considered. VAT upon transfer of a NPL portfolio needs to be taken into account on a country-by-country basis as some countries may consider the sale/acquisition of NPL portfolios as factoring, which may make VAT irrecoverable. Furthermore, VAT may be due on debt collection services; however, proper structuring may mitigate this.

### Servicing

Domestic special loan servicing capacity and capabilities, and future deal flow in each region, will determine whether investors seek to partner with local servicers or build/acquire their own platforms. In the UK, servicers are facing significant challenges adjusting to the current credit conditions with special servicing capabilities at scarce supply.

### Current deal activity

We have recently seen sales of NPL portfolios (corporate, consumer, secured and unsecured) in Poland and Greece and currently anticipate further sales in Spain, Greece and the Czech Republic – in addition to the various Lehman Brothers European portfolios. This indicates that despite the current market conditions, there remain willing buyers and sellers of distressed debt.

# Investment Management and Real Estate contacts

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