

BANKING & CORPORATE FINANCING | BY [GIFFORD WEST](#)

Managing mounting NPLs

European default rates, most notably in the UK, Spain, and Portugal, have begun to climb sharply after hovering at historical lows. While residential and commercial real estate (CRE) bankers may debate how bad it's going to get, the days of lightly staffed workout teams consistently generating high recovery rates are over. No credible market commentator is projecting double-digit growth of real estate prices any time soon.

Without underlying strength in the marketplace, the safety net that has protected the workout function has been removed. Senior bank managers need to brace themselves for some very unattractive times ahead. Few want to repeat the experience of the US, where banks slowly transitioned from lending institutions to poorly performing real estate investment trusts as their balance sheets became increasingly dependent on the value of the collateral versus the credit risk of the borrower.

So what are a bank's strategic options in today's market? In the short term, it is likely that workout staff will manage the increased flow, but two factors highlight the need for expanded capacity very soon. First, there has been an enormous increase in standard distressed debt due to default rates on plain vanilla residential loans soaring 200 percent in six months in some markets. Second, the collapse of supposedly safe exotic loans will require the acquisition of specialist knowledge to deal with a wide range of products, such as foreign banks' holdings of supposedly safe senior tranches of Florida condominium construction loans.

Three solutions

Bank executives can use any combination of the following three strategies to tackle the problem of mounting problem loans: (i) hire/transfer additional staff into the function; (ii) outsource the function to a third party special servicer; and (iii) conduct loan portfolio sales.

Staff deployment. Given that many European banks have dramatically curtailed their origination function, there is a seductive charm in transferring staff from the origination to the workout function. Staff numbers are retained, the function is kept in-house, and the pain associated with lay-offs is avoided. This strategy is most effective when staff expertise is closely related to the loans in workout. It's easy to see the rationale of moving residential loan originators to residential workouts or CRE originators to the CRE workout group. However, there are significant drawbacks to this approach. First, workout specialists and originators frequently have different skill sets. While there may be some overlap, these functions are fundamentally at odds. With the stakes high, it's critical that the proper expertise and experience is deployed to work through the problems as rapidly as possible.

Second, the staffing conundrum is exacerbated in markets where labour regulations are tight. German banks seeking to unwind their large non-performing loan (NPL) portfolios often confront an unexpected dilemma. While many bidders exist for their portfolios, few banks are willing to take the associated workout staff as part of the transaction. That's because unions, backed by labour law, are largely inflexible about sizing down the workout staff once the NPLs are sold. In some cases, German banks have found themselves in a vicious cycle of being unable to sell their portfolio due to excess staff costs after the workout problems were resolved. Unwittingly, banks became large special servicers with a small loan origination team.

This article first appeared in *FinancierWorldwide's April 2008 Issue*.

© 2008 Financier Worldwide Limited. Permission to use this reprint has been granted by the publisher. For further information on FinancierWorldwide and its publications, please contact James Lowe on +44 (0)845 345 0456 or by email: james.lowe@financierworldwide.com

The outsourcing option. Outsourcing in most labour markets is a more attractive option. Most third party servicers have increased flexibility in hiring and firing. Consequently, a fixed cost can be turned into a variable cost. Similarly, special servicers have the capability to ramp up quickly while maintaining a corporate culture that leads to higher recoveries when the firm properly motivates its personnel.

While many European banks express concern about the potential damage to their reputation of having third parties collect bad loans, very few such cases have actually materialised in the past 10 years. It is never in the special servicers' interest to have negative media coverage, and most do everything they can to avoid it. Bad press helps neither their business nor banks.

The least effective outsourcing approach is to engage a law firm. While law firms have the legal knowledge associated with a country's legal system, they are more expensive. Law firms are focused on hourly billings. Special servicing requires an efficient, results-focused operation that few law firms can deliver. The focus should be on compensation to reward results and an efficient data feeding process to the bank's management information system.

Loan sales. Loan sales are an increasingly effective workout strategy in the US and Europe. In the past five years, a large and growing pool of distressed debt investors has expanded from the US to most major global markets. Today, the market in Germany is well developed and extremely efficient. In the next 12 to 18 months, the UK and Iberian markets are likely to achieve the same level of efficiency. Most legal and data security issues have been addressed.

Loan sales are highly effective because they demonstrate that problems have been dealt with in their entirety. There are no lingering doubts about whether a bank has reserved adequately. As a result, the bank's staff can focus on originating new business instead of speculating on real estate and corporate equity – the de facto role that large workout teams take on.

From an investor perspective, selling problem loans efficiently can remove the earnings headwind many banks with large NPL positions often face, while opening up strategic opportunities in the consolidating European banking market. A word of caution however. Ensure that the asset sale agreement does not contain onerous representations and warranties and beware of bilateral transactions in which the buyer has all the leverage to walk the terms down.

Plan now or regret later

For at least the next year, loan losses are likely to climb. The challenge to senior bank management in this environment is to adjust accordingly to protect shareholder's equity, retain staff flexibility and maximise overall return. As with all management, strategy is about making difficult decisions. Left to its own momentum, banks will drift into a model of a large workout department expanding to meet a growing flow of troubled loans. Experience appears to show that this path does not serve bank shareholders or management in the long run. ■

Gifford West is managing director and head of European operations for DebtX. He can be contacted on +1 (617) 531 3400 or by email: gwest@debtx.com