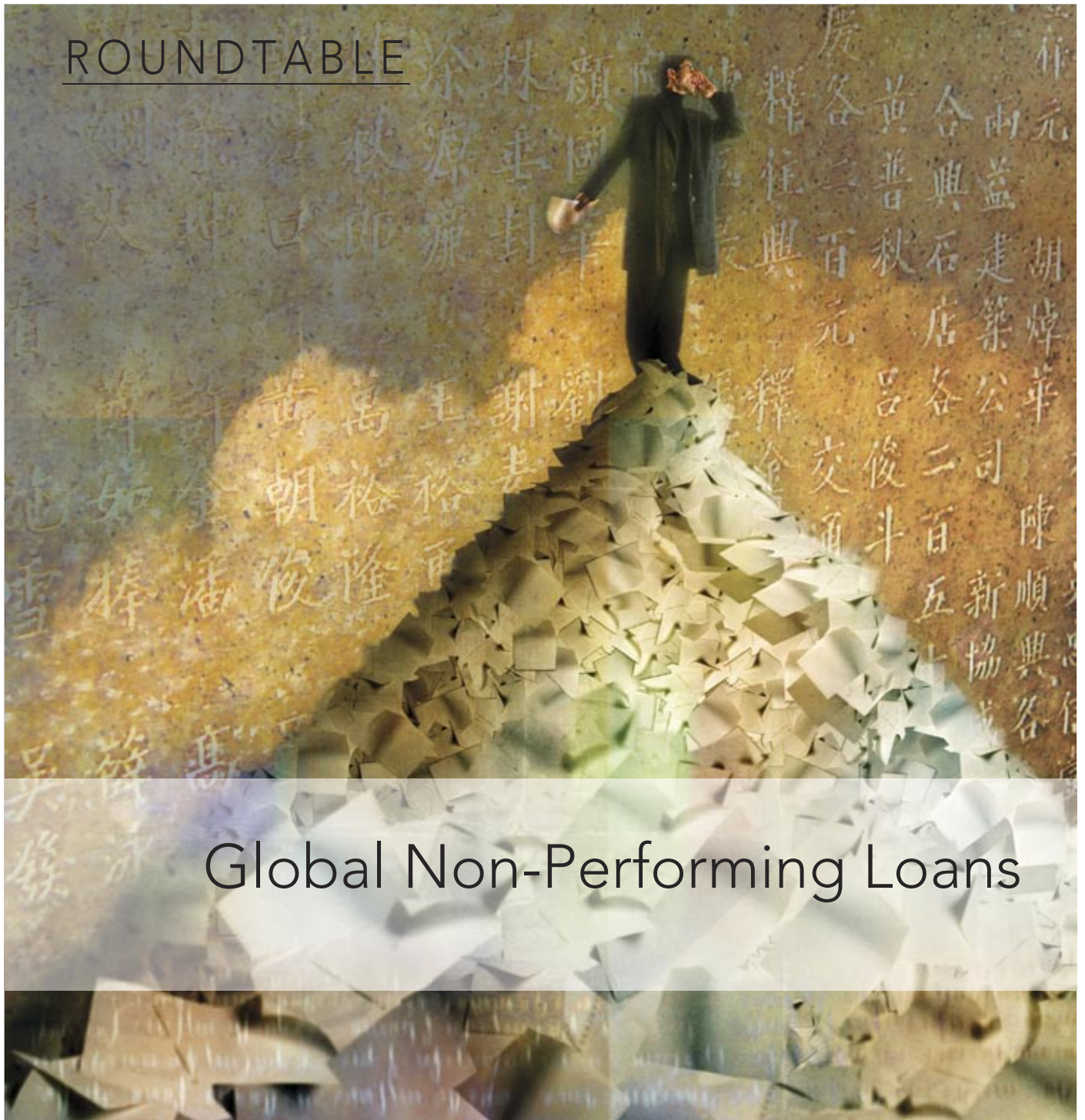


## ROUNDTABLE



## Global Non-Performing Loans

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## GUEST MODERATOR



**Jack Rodman**

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Mr. Rodman presently lives in Beijing, China, where he is focused on helping Chinese Banks resolve their NPL problems through international auctions or structured joint ventures with foreign investors. To-date, Mr. Rodman has served as Financial Advisor to the People's Bank of China and three of the four State Owned Commercial Banks while closing the two largest international NPL auctions in China on behalf of China Huarong Asset Management Corporation.



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Vincenzo Paparo is a partner in the Corporate Department of Proskauer Rose LLP where he co-chairs the Finance Group, concentrating in the areas of commercial lending, corporate finance, workouts and restructuring. He represents investment funds, financial institutions and finance companies.

## GLOBAL ISSUES

**Rodman: How can the sale of NPLs benefit the domestic economies in which they are active?**

**Paparo:** Quick resolution of NPLs permits the financial institution to return to a lending mode sooner, minimising losses, fostering new lending and thereby fuelling economic growth.

**Rodman: What methods can banks actively implement to reduce their NPL exposures in the future?**

**Paparo:** Well-structured transactions with strong underlying documentation that clearly and correctly delineate the lenders' legal rights, will go a long way towards avoiding NPLs. When problems invariably arise, the liquidity of the secondary debt market will be easier for the financial institution to access with properly documented laws, and thereby garner palatable prices, which in turn will help reduce NPLs to acceptable levels.

**Rodman: What are the key issues for investors when targeting NPL opportunities?**

**Paparo:** Investors look at asset quality, pricing and likely rate of return on the collateral. In addition, the quality of the underlying loan documentation and the attendant legal rights and costs associated with enforcing the rights under the loan documents in a particular foreign jurisdiction are critical factors when determining risk.

**Rodman: What are some of the structural and procedural considerations that advisers take into account when acting on behalf of banks to dispose of an NPL portfolio?**

**Paparo:** The legal advisers to the financial institution will seek to ensure that all of the applicable loan documentation is

assembled, that confidential communications are preserved and the files generally reflect the proper legal status of the loans being marketed to investors.

**Rodman: Are there often major differences between the due diligence performed by buyers and sellers at the time of sale, and the actual performance of the assets over time?**

**Paparo:** The seller has lived with the NPL portfolio for a much longer period of time than the investor, who must rely upon the quality of the due diligence materials provided by the seller prior to making an offer. The seller will often see greater value over the long term where in contrast an investor will seek to hedge its risk by discounting certain positive factors in light of its limited exposure to the NPLs. Many experienced investors have developed a fairly sophisticated matrix for evaluating NPL portfolios and their likely return.

**Rodman: What are some of the difficulties that arise when valuing an international NPL portfolio comprised of diverse collateral?**

**Paparo:** The ability to establish a worst case liquidation scenario is another problem. The investor must familiarise itself with the regional and local laws which might impact the value of the collateral and the ability to seek judicial relief when it is contemplating a timely recovery from the liquidation of the collateral.

**Rodman: What representations and warranties on the description and nature of the assets or security should be required of the seller?**

**Paparo:** At a minimum, an investor should receive representations and warranties which state that the collateral for the loan is described accurately and fully by the loan documents. However, expecting a financial institution to rep and warrant the priority ►►

of the lien position or the nature of the collateral will be difficult to obtain and somewhat unrealistic to expect. Sellers, for practical and legal reasons, often try to minimise representations and warranties. This tendency is reflected in the debt trading rules promulgated by the LSTA and LMA.

**Rodman: How can the gap between what investors are willing to pay and what banks can afford to accept be bridged?**

**Paparo:** Financial institutions should value NPL portfolios based upon what the market is willing to pay for those assets versus what the financial institutions believe they can recover if they workout the loans. Investors on the other hand will need to have greater access to updated information regarding the credit, confidence in the enforceability of the loan documents and their ability to obtain access to the underlying collateral for liquidation purposes.

**Rodman: In what ways can financial, accounting and legal deal advisers work together to maximise results for their clients?**

**Paparo:** The various advisers must communicate to each other their methodology and conclusions to ensure that the pricing recommendation does not fail to consider all material factors which can affect the ultimate recovery for the investor or the financial institution.

## EUROPEAN MARKET

**Rodman: Germany is being touted as the European centre of interest for NPL investors. What are some of the notable aspects peculiar to the German market, which buyers and sellers will have to keep in mind?**

**Paparo:** Current estimates of NPLs in Germany are approximately €300bn, however, there are significant regulatory and accounting considerations, which are making NPL portfolio sales difficult to consummate. One of the significant issues is the amount that investors are willing to pay versus the value ascribed by the German banks to their NPL portfolios. Due to the favourable creditor laws in Germany many German financial institutions have, and rightly so, carried high valuations for their NPL portfolios. In addition, German NPLs tend to be underperforming loans rather than distressed or charged-off loans where the likelihood of the loss is significantly higher. Finally, Germany has a strong and growing economy. Investors who do not consider these factors will likely not be prepared to pay higher prices for NPLs which they mistakenly believe might negatively impact their rate of return.

**Rodman: Are there any factors that may interrupt successful NPL deals taking place, and German banks moving the estimated €300bn from the books?**

**Paparo:** Given the high book value of the respective NPL portfolios of German financial institutions, there is a fundamental disconnect between their expected recoveries versus the amount an investor would typically be prepared to pay to purchase an NPL portfolio.

**Rodman: What impact will Basel II have on banks' attitude towards NPLs and what measures are we seeing banks take in preparation for the regulation?**

**Paparo:** Basel II will drive many financial institutions to reevaluate their current method of capital risk management. In addition, financial institutions planning to adhere to the Basel II accord will sell NPLs in order to meet the capital requirements and to minimise any future charges to the financial institution's capital as a result of Basel II. This process should result in an increase in NPLs availability in the secondary debt market.

## ASIAN MARKET

**Rodman: Although there has been some fanfare regarding foreign investors entering the NPL arena in China, only a handful of transactions actually closed. Why is this?**

**Paparo:** There are a number of significant reasons, not the least of which is that the international investment community has been awaiting the adoption of bankruptcy law reforms which should result in a more 'creditor-friendly' and transparent bankruptcy process and therefore a more attractive environment for NPL purchases and sales.

**Rodman: In what ways – and with what success – has the Chinese government attempted to tackle the country's NPL problem?**

**Paparo:** Chinese banks continue to have significant NPLs notwithstanding the AMCs, proposed new bankruptcy laws and efforts to facilitate sales of NPLs to international investors. It remains to be seen how effective these reforms will be in reducing NPLs in the long term if basic loan underwriting and documentation standards are not strengthened by the financial services industry.

**Rodman: Looking ahead for the next 6-12 months, how do you see the deal pipeline for distressed assets shaping up around the globe?**

**Paparo:** The situation in Europe is somewhat better with some attractive investment opportunities in Germany and, in particular, senior bank debt and mezzanine loans. The market in the US will remain weak through 2005 given the strength of the economy. ■