

Clients & Friends Memo

Opportunities and Challenges in the German Non-Performing Loan Market

6 May 2004 Current German economic conditions and the on-going drive towards reform and consolidation of the German banking market have created a uniquely favourable environment for the creation of a significant market for the purchase and sale of portfolios of non-performing German commercial property loans (NPLs).

This article explores the background to the German NPL market and some of the legal and practical issues that will arise as the market develops and matures.

Market Overview

Germany has one of the largest and most diversified banking markets in the world. Although there are no official figures, it has been estimated that German banks have a total lending book of over € 3,000 billion spread over approximately 3,800 banks. Conservative estimates (based on the application of JP metrics) put NPLs at between 8 and 12 per cent. of this or almost € 240 billion.

The last year has seen significant activity by a variety of international investment banks and investors in the German NPL sector. However, to date relatively few sales of NPL portfolios have actually completed. In November 2003, Goldman Sachs acquired all of BW Bank's non-performing loans to real estate company WCM. Also in November 2003, Munich-based Hypo Real Estate AG completed a € 490 million sale of a NPL portfolio to a joint venture between J.P. Morgan Chase and the US investment fund Lone Star following on from a similar smaller acquisition last year from Gontard & Metallbank AG and the market anticipates that senior debt finance for this portfolio will shortly be the subject of an internationally offered securitisation. There are reports of on-going negotiations for the sales of up to ten further NPL portfolios in Germany. However, for the reasons discussed below in relation to regulatory capital accounting, it is not yet clear if these transactions will be able to overcome the pricing issue that arises for many German NPL sellers and successfully complete.

What is a German NPL?

International (particularly US) investors may have a different definition of what constitutes a NPL from that used by German bankers. German NPLs tend to be "sub-performing" rather than actually "distressed". German NPLs generally have not been "written off" by the originating

bank but are merely the subject of a major covenant breach which may (but will not necessarily) include one or more missed principal and interest payments.

Unlike NPLs originated in countries such as France or Japan, relatively few German NPLs are straightforward bi-lateral loans. Many have been sub-participated and so the selling bank (and hence the purchaser) may not have the right (as majority lender) to direct security enforcement and loan work out. Others are the subject of federal, state or municipal guarantees or subsidies from entities such as *Kreditanstalt für Wiederaufbau (KfW)*. These guarantee and subsidy arrangements may be for the entire amount of the loan or only for parts thereof. The terms of the guarantee or subsidy may also give the guarantor or subsidy provider control or consent rights which may affect any work out of the loan and add a further party (and layer of complexity) to negotiations with underlying borrowers.

The final complication is that many smaller German commercial loans are prepared by the in-house legal department of the originating bank on the basis of relatively simple standard form documents in the German language. These documents can be very different from those with which international investors are familiar.

The Regulatory Framework for NPL Sellers

Many German banks seem to have taken the approach of valuing their loan portfolios for regulatory and accounting purposes on the basis of their expectation of total recoveries from the loans over a protracted period of time rather than the amount that a third party would pay to purchase the portfolio on arms' length terms at a particular time.

Given, Germany's "creditor friendly" legal system and (at least in the long term) fundamentally strong economy, where German banks take this approach, they can reasonably expect high (if not full) recovery levels even on non-performing loans and hence often give high book values to their NPL portfolios. Another possible justification for this approach is that there is as present, no fully functional market in German NPLs in existence and so market valuations can be difficult to obtain and may be of questionable reliability.

The difficulty presented by this arises where (as is usually the case) investors in NPLs seek to pay significantly less than face amount. This may result in substantial differences between the amount investors are willing to pay for a NPL portfolio and the value ascribed by the originating German bank to such portfolio in its asset books.

Where this is the case, the difference between these amounts will, if the sale completes, constitute a deduction from the originating bank's Tier 1 regulatory capital. Some banks will be willing to accept this as the price to be paid for disposing of their NPL portfolios. However, others will find that they simply cannot afford to make such a deduction from their regulatory capital and accordingly will be unable to sell unless they can raise substantial new regulatory capital (as HVB recently did) or they accept that that the book value of their NPL portfolios as

stated in their annual accounts differs substantially from market value which is likely to be unpalatable due to the resulting personal liability for their officers

Clearly this situation presents systemic risks for the German banking industry as a whole, with the resulting retention of large NPL portfolios by the banks causing downward pressures on the valuations of share prices for such banks making them targets for takeovers by foreign banks. While the German authorities have taken action to promote true sale securitisations of German originated assets, such as revisions to the trade tax law and the “true sale initiative” (or TSI) (which relates only to performing assets), there seems at present to be no prospect of any official regulatory or state action to deal with the issues relating to the disposal of NPL portfolios. Indeed, the TSI itself may actually increase the systemic risk presented by NPLs for the German banking industry as if German banks use the TSI to dispose of large amounts of performing loans, their performing loan to non-performing loan ratios will disimprove. This lack of remedial action may in part be due to a reluctance on the part of bank officials to raise the issue with the regulators for fear of accusations of misstating their accounts.

Unless and until official guidance is available on this, it will fall to investors and sellers to devise structures to at least minimise some of the worst effects of this mismatch.

The Experience in Other Countries

Recent years have seen lending institutions in countries such as Japan, France and Italy face similar situations regarding their NPL portfolios. French and Italian banks were able to take advantage of *Banque de France* or state guarantees, respectively. However, this option is not available in Germany because the *Bundesbank*, has no mandate to issue guarantees in favour of the German credit institutions.

In Japan a similar situation has been overcome through establishing joint venture vehicles between the selling bank and the investor to acquire the NPL portfolios and subsequently distribute the proceeds in accordance with a shareholders agreement. However, the German Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht – BaFin*) has indicated that where the originating bank retains any interest (even where such an interest is structured to be as minimal as possible) in the acquisition vehicle, the disposal will not be treated as a “true sale” for regulatory purposes and the entire NPL portfolio will remain on the originating bank’s regulatory balance sheet.

At the same time, the proposed capital regulatory changes that will be implemented with Basel II, will increase capital regulatory requirements for typical commercial mortgage loans (defined as IPRE loans under Basel II) from 100 per cent. of the 8 per cent. base capital reserve requirement to up to a range that increases to 625 per cent. in the case of defaulted loans.

In each of the abovementioned countries, the relevant bank regulators took a pro-active approach to the issue of NPLs. However, in Germany the *Bundesbank*, the regulators and the

federal government have not yet even acknowledged that the NPL portfolios held by German banks present any issues or risks at all for the German banking sector.

Structuring Solutions

A number of participants in the market are currently working on innovative structures which seek to minimise or defer some of the worst consequences of sales of NPL portfolios for German banks which face this issue. This is not expected to be an easy task as any solution will require the approval of multiple regulators and auditors both internally and externally up to and including the level of the Basel Committee's working group on securitisation and credit derivatives. However, once the first transaction has completed it is expected that the process will become relatively easy.

The other side of this question is how will a disposal of a NPL portfolio be treated in consolidated accounts prepared under International Accounting Standards (IAS) by a selling bank. Given the underlying principals of IAS, this will be a much harder issue to solve. However, the entry of US investors into the German NPL market has brought a wealth of experience of dealing with similar situations in the context of the work outs that resulted from the US Savings & Loan crisis of the early 1990s and it may prove possible to import some US technology on this point.

Servicing German NPL Portfolios

Further issues arise for any person who acquires a portfolio of German NPLs in relation to their servicing. Although collecting amounts due under loans and related administration work is an unregulated activity under German law if no accounts are held or administered in Germany and, as such, may be carried out by anyone, the German *BaFin* has indicated that the process of working out a loan (i.e. enforcing security, re-negotiating loan terms and payments, etc.) requires the involvement of an entity which is licensed as a German credit institution or which is passported under the EU Investment Services Directive (i.e. authorised to carry out similar activities in another EU member state).

Many NPL investors (particularly US investors) will not have such a licence and so will need to partner with a bank that is so authorised in order to be able to deal with NPL portfolios as intended.

In the past, German banking secrecy laws and the German Data Protection Act have been viewed as obstacles to the dissemination of information on NPL portfolios to potential purchasers. However, the German *BaFin* has approved such disclosure provided that the recipients undertake to keep the information confidential.

Finally, any servicer of German mortgage loans will need to be aware of the trade secrecy provisions of the German Act against Unfair Competition (*Gesetz gegen den Unlauteren Wettbewerb*) and (in relation to sanctions) the German criminal code (*Strafgesetzbuch-StGB*).

These may limit the ability of servicers, particularly in work out situations, from reporting on work outs to investors and even from sharing information with advisers, accountants, etc.

We are presently preparing a detailed briefing on all aspects of German data protection and banking and trade secrecy law in the context of commercial property securitisation. This will be distributed shortly and will also be available through the websites referred to below.

Conclusion

Germany at present seems to present a close to ideal environment for both German banks to divest themselves of potentially risky portfolios and for international investors to reap the benefits of their experience of managing and working out non-performing loan portfolios. However, significant obstacles will have to be overcome. Guidance from the German banking regulators would provide considerable assistance with this. Accordingly, the speed and extent of the development of the German NPL market remains to be seen.

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