# Role of Private Equity in Resolving NPLs - With special reference to Europe

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That amount of borrowed money on which schedule payment has not been made by the debtor for at least 90 days is called Non Performing Loan. According to IMF,"

Private Equity (PE) refers to any type of equity investment in an asset in which the equity is not freely tradable on a Public Stock Exchange. It includes Venture Capital, Growth Capital, Leverage Buyouts and Angel Investing.

PE are valued for the skills, expertise and network they bring besides Finance for the business which other finance providers are unable to provide.

As per World Bank NPLs reached 12.6% of gross loan portfolio in developing European and Central Asia Countries in 2011. EURO Zone banks are also facing very difficult financing conditions. The average NPL rate in the region amounted to 6.1% in 2011.

According to a survey report made by Ernst and Young, the markets with the most opportunities are UK, Ireland, Germany and Spain.

In disposal of NPLs, Private Equity can play an important role. PE investors command a better position over the corporate buyers as generally it is more difficult for Public Companies to purchase distressed assets or companies because of investment constraints, given the funding, liquidity and financial reporting challenges associated with NPLs. Moreover the objective of PE companies is to take over such type of assets to make them more profitable by introducing their expertise, advanced management techniques and finance, which other finance companies are unable to provide.

Top Italian banks are trying to tap PE for help with their troubled loans. Italy's top two banks Unicredit and Intesa Sampaolo have signed a deal with US Private Equity firm KKR to pool some of their problematic loans as company's lender seek new ways to grapple with soured loans.

Through this research paper, I want to brief on the latest Global trends of market of NPLs and their reflection o the European Markets and also the role of Private Equity in resolving NPL problems of the banks.

## Role of Private Equity in Resolving Non Performing Loans
### (With special reference to Europe)

In the last two decades, the world had witnessed three main Financial Crises. An examination of these financial crises brings some common practices such as poor regulatory oversight, suspected accounting and economic liberalization. The idea of liberalization has been in the air for more than a century and recent times.

Liberalism which goes back to Adam smith and extends to Keynes promoted free transaction while keeping the role of State limited to important welfare activities. In the first half of last century (the 20th century) the traditional liberalization had led to its gradual decline as an ideology.

Shortcomings of Liberalization gave rise to Neoliberalism, which brought many changes to classic liberal concepts. Neoliberalism as defined by Harvey (2005) is a model of Capitalization which focuses on the economy and its deregulation to enable a free market based economic system. In this view, government intervention in the management of the economy is unnecessary and unwise because the market is a self-correcting mechanism. (Bedar 2006, a, 8). But due to lack of government expenditure the free market economy works temporarily by speeding on credit to low income to keep consumption going. But when people are unable to pay back the borrowed money, the economy runs into crisis. (1)

Although Neoliberalism succeeded in achieving some of its main objectives in Western countries such as reducing inflation and labor wages but they failed to achieve basic objective that is to encourage investment and economic growth. The Neoliberalism has impacted on the financial sector which was one of the reasons for the 2008 financial crisis.

Non-Performing loan was a product of financial deregulations. Financial deregulation freed banks to pursue whatever financial policy would bring the highest profits. The upward trend of NPL started immediately with the outbreak of the financial crisis in 2008.

*"Global Financial Meltdown and the demise of Neoliberalism' by Prof. Akbar e.Torbat, Global Research, October 2008 News latter

**Non-Performing Loans**
A sum of borrowed funds on which the borrower has not made his scheduled payments (neither interest nor principal amount) for at least 90 days.

### Private Equity

Private Equity refers to the money invested in firms which have not gone Public and as a result are not offered on any stock exchange. Private Equity firms generally invest money in underperforming companies which they believe can do much better.

## Banking at International Level

At International level, Banking crisis are common and often lead to increased financial burden on the tax payers. For example, in late September, Treasury Secretary Henry Paulson urgently asked for $700 billion, more of the tax payer's money to purchase bad debts from the banks that were close to fail (2). The Banking crisis in Japan until 2001, in which a huge public fund was used during the financial crisis, amounted to 5 % of GDP. Asian crisis which happened in 1997, involved 20% of total Bank loan while 27% in Thailand credit.
Over the past one decade, the quality of loan portfolios across most of the Economies had been stable in the world till the global crisis hit the World Economy in 2007-08. Since the global financial crisis began in 2007-08, the international financial situation has been that loans are good until there is 100% certainty that the borrower will pay back the whole amount under existing arrangement.

(2) “Global Financial Meltdown and the demise of Neoliberalism’ by Prof. Akbar e.Torbat, Global Research, October 2008 News latter

NPLs in European Markets& USA

NPL to total gross loan %

| Country | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|---|---|
| France | 2.7 | 2.8 | 4.0 | 3.8 | 4.3 | 4.3 | 4.5 | - |
| Germany | 2.7 | 2.9 | 3.3 | 3.2 | 3.0 | 2.9 | 2.7 | - |
| Italy | 5.8 | 6.3 | 9.4 | 10.0 | 11.7 | 13.7 | 16.5 | - |
| Netherland | - | 1.7 | 3.2 | 2.8 | 2.7 | 3.1 | 3.2 | 3.0 |
| Switzerland | 0.3 | 0.9 | 1.0 | 0.9 | 0.8 | 0.8 | 0.8 | - |
| U.K | 0.9 | 1.6 | 3.5 | 4.0 | 4.0 | 3.7 | - | - |
| U.S.A | 1.4 | 3.0 | 5.0 | 4.4 | 3.8 | 3.3 | 2.5 | 2.3 |

Source: World Bank Group 2015

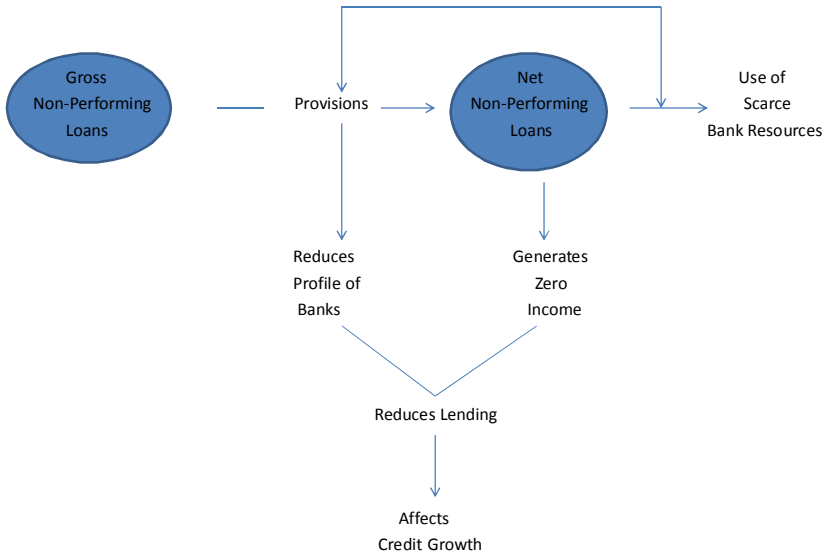
- Figures not available

## Banks and NPLs

Banks need to handle these NPLs very tactfully as they not only affect the balance-Sheet of the firm, nor do they create any income. It is important for banks not to conceal their NPLs in their balance-sheets and present a more realistic picture of their financial position.

In addition, NPLs involve not only human and operational resources but also incur legal and administrative costs which otherwise could have been used for increasing the new lending. The impacts of NPL on the banks have been depicted in the following diagram:

Mapping the impact of nonperforming loans on credit




Source: Author

Thus, banks need to clean their balance-sheet from these NPLs.

## How to clean the Balance-Sheet of a bank?

Banks can solve their NPL problem either through Restructuring of the loan or by creating Capital reserve in their B/Ss. Restructuring of credit facilities means all loans which have been modified with respect to their repayment schedules, such as granting or extending of loan period on capital and interest or may be post-ponement of payment of one or more installments. However, some of banks have restructured their bad loans. But it is generally noticed that the restructuring of NPL is not only time- consuming but also a complicated process, which ties up bank resources. Loans still remain in the books of the Banks. Creating reserves towards bad loans results in eroding of profits and still leaves the problem of NPLs in the B/S of banks. Another option would be to create ,"A Bad Bank" in the country which will buy stressed assets from banks at a nominal discount to book

value. But here the problem has not solved fully but has shifted from one place to another and the tax payers would bear the bill for NPAs which would be away from bank's books but will be available at Bad Bank's books.

Besides above, the next alternative for banks is to settle the loans with the borrower for a lower repayment and sell the assets to new investors. This will clean the B/S of the bank. Banks themselves are unable to run these assets as they do not have the required experience workout platforms. So to make the stressed assets fruitful, it's better to sell to investors who know how to work out.

Investing in non-performing assets is not always a passive business. Investor must be willing to accept significant risk. It requires expertise knowledge of Bankruptcy laws, expertise of negotiation with stakeholders, skills- to accurately assess if the stressed company can be made profitable through improved operations and successful reorganization and action, from the very start.

Because of the risks involved and expertise required, forward Institutional Investors such as Hedge Funds, Private Equity Firms and Investment Brokers are the major buyers of NPLs.

## Why Private-Equity firms?

Private Equity not only provides finance but also helps the stressed business and makes them much stronger through their hard work, expertise and research. That is why private equity funds are ploughed into firms that are underperforming and are believed to be able to do a lot better.

The position of a Private Equity buyer is at an advantage position in comparison to a corporate buyer in handling a non performing asset. A Public company has investment constraints, such as funding, liquidity and financial reporting challenges associated with distressed companies.

Private equity firm can take the company private while a corporate buyer will not be able to take as such. A public company has to fulfill certain requirements given in their MOM and AOA. Like public company, Private equity firm is not answerable to a number of stakeholders. This way, the private equity firm with its expertise knowledge can improve operational performance of the distressed asset without any pressure from the public. By contributing restructuring expertise knowledge and additional Equity the private equity firm may help in increasing the revenue of the asset.

Top private equity funds can earn Internal Rate of Return from 20-25%. In the past also Private equity firms have been to withstand shocks. It is no wonder private equity investors have come out of the global crisis with an organic growth,

through their expertise entrepreneurial knowledge and skills to working with their portfolio companies. A few private equity funds have robust distressed investing platforms and for them the future is bright in terms of reputation, deal flow and returns.

For the last one and above decade, distressed debt investing has become well known phenomena among private equity firms. Selling of NPL is not an easy task for a Bank. A bank needs to be careful to have a proper and transparent selling process. Banks need to see that it gets a right party for the loan and of course a right value for the loan portfolio. The distressed debt market has increased in size and private equity firms have become Key-Players.
In USA, bankers preferred to sell the troubled loans rather than rely on workouts as the primary NPLs management strategy. US banks have been able to clean their B/S in a short period by selling NPLs.

## NPLs and European Banks

European banking system is quite large in comparison to other banking system in the world. European banking is changing. The structured developments mandated by Basel III and changes by other regulators and the overall environment in Europe have created a new set of opportunities for investors and borrowers with new risk and returns.
Distressed debt whose 100% birth place was USA, now are moving to Europe. 85% of corporate debt is financed directly by banks in Europe in comparison to 25% corporate lending in US.
For few years after the Global Financial crisis, European banks were reluctant in selling their corporates loans expecting losses on sale. Blackstone Group LP collected more than $4 billion in 2009 to invest in European property assets expecting that banks would be forced to sell their NPLs due to global financial crisis. Almost all of it sat idle for two years. Today, the inaction has created a surge of deals of sales of Loan portfolios by European Banks that it has sold 91 billion Euros as NPLs in its books in 2014. (PWC report March' 2015)
European banks are overburdened with bad loan problem similar to what US faced few years back. High and rising levels of NPLs in the euro area have not only

burdened B/S of banks but also affected negatively on bank profits. After global crisis, as Europe is emerging, Government and regulators are concentrating on clean and strong balance sheets. In 2011, the European Banking Authority (EBA) realized that the large European banks were undercapitalized by 242 billion Euros against the requirements of Basel III 2019. According to the federal Deposit Insurance Corporation's (FDIC) definition of "Well Capitalized" which is 5% on unweight assets, the EUROZONE's banks would run short of EURO 400 billion which is equal to 4.2% of GDP (the European Market and the Deleveraging Opportunities, March 2014)

But for the last few years, some European lenders have reversed their stand as they found a jump in demand for these assets. Moreover banks have also found that it's better to change the composition of their Balance-Sheet, partly because legacy assets are less profitable than new lending.

The Report entitled "Flocking to Europe" by Ernst and Young, looks Europe emerging as a sizable NPL market in its own right headed up by Germany as the most investing market followed by UK. Conducting of Asset Quality Review and then declaring the result by the European Central Bank also puts pressure on banks to unload their bad assets, has also been an encouraging factor for some European banks to increase their sales.

European Banks will have to gradually meet the new Basel III minimum International Capital requirements. This is one of the reasons due to which the sale of troubled assets has increased. Increase in sale of distressed assets by banks has increased competition in the distressed investment market which has further resulted in increase in prices which further has made more attractive for banks to sell their distressed assets.

"Europe is one of the World's greatest investment opportunities" according to David M. Rubersten, who is a co-founder of Carlyle, "there is no part of the world that will see so many assets sold at a discount as in Europe"

Six years after the Global financial crisis, European banks continue to sit on around 1.9 trillion Euros of unloaded loans, equivalent to 4% of European banking assets, says PWC report (March 2015). During last year, pressure from regulators to clean the B/S, has forced European banks to unload loans at record level. The major portion of debt portfolios have mostly been snapped up by private equity firms who analyze the portfolios and with their expertise skill, make the concern profitable business.

During 2014, banks sold loan portfolio with a face value of 91 billion Euros, (Mostly by banks from UK, Ireland, Spain and Germany) an increase of around

40% of total volume of loan sold in the previous year (banks sold 64 billion Euros in 2013). Banks in Europe sold nearly 65 billion Euro ($75 billion) of Commercial and residential property loans in 2014, compared with 27 billion Euros in the whole of 2013 and 19 billion Euro in 2012, according to Price water house Coopers report on March 2015.

PWC research further showed that Italian banks hold more NPLs than any other European country estimated by PWC to be some 185 billion Euros which is roughly 15% of total NPL across Europe. Loan portfolio transaction in Italy in 2014 totaled just 8 billion Euros and is expected to sell a total of more than 15 billion in 2015. In Italy sales accounted for only 1% of bad debts in 2013 and consisted mainly on highly provisioned loans whose book value had already reached to negligible amount. As per the market requirements, these loans should have sold before the global financial crisis.

The big buyers of NPLs are Private Equity firms, including US giant such as Blackstone Group LP and Lone Star Funds. In one single deal, German Lender sold a portfolio of Spanish Property for about 3.5 billion euro to Lone Star and J.P Morgan & Co. during June, Last year.

In total, 81% of distressed loan transactions in Europe were acquired by US private equity firms last year, according to broker CBRE Group Inc.

## Conclusion:

Removing old debt frees up capital for the extension of new credit- a pillar of growth for an Economy. Basel III, an increasingly demanding capital regime, will be fully implemented by 2019. Its full implementation which is an increasingly demanding capital regime will further impact deleveraging. Many banks may find that their funding and capital structures will not be maintained and as such, asset sales of NPLs are the easiest way out. Moreover, the recent European Central Bank's Asset Quality review (AQR) will lead to further asset sales from across Europe by making it tougher for banks to hide NPLs and forcing them to raise provisions. According to PWC portfolio loan of 100 billion Euros will be traded in the current year (2015) in Europe.

I am very positive that seeing the need of the European banks to divest NPLs portfolios as per the Capital Adequacy Requirements and attractive prices of NPLs are likely to provide further opportunities for the Private Equity firms who have gained significant experience in loan portfolio evaluation in the years following the Global Financial crisis and converting them into profitable ventures.

Thus, opportunities for Private Equity firms within the NPL space are great and prominence of private equity firms in NPL deals are here to stay in the coming years.

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