Intralinks® Special Report

What to Expect from Non-Performing Loans (NPLs) Post-Crisis

Looking beyond COVID-19 and back at the 2008 financial meltdown

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Introduction

Debt plays a crucial role in global finance since it's typically a less-expensive way for corporations to raise capital. Total debt is on the rise, reaching USD 250 trillion in the first half of 2019[1], according to the International Institute of Finance, suggesting a plethora of investing opportunities. Yet challenging business cycles often make it difficult for corporations to repay debt. When neither principal nor interest payments have been made for 90-180 days[2], these loans are classified as nonperforming (NPLs). Investors seeking more attractive yields in this low-rate environment can benefit from this diversifying asset class, as safe-haven vehicles, particularly in Europe, are generating negative yields.

Globally, economies are reeling from the COVID-19 crisis. In Asia-Pacific, which endured the pandemic slightly ahead of the rest of the world, it is forecasted that nonperforming assets in the region could rise by a whopping USD 600 billion.[3] This is due to the combination of COVID-19, rock-bottom oil prices and market volatility. As the global fallout from the COVID-19 pandemic crystalizes, it raises many questions: What will be the impact on NPLs as corporations attempt to shore up their balance sheets by offloading debt? Will investors be deterred by a spike in loan default rates, or will negative-yielding, safe-haven alternatives encourage them to invest in NPLs?

More debt in the market could signal an abundance of opportunities for investors. Sellers will be challenged to streamline their workflow. This means establishing efficient ways to reach potential investors, expediting due diligence to assess the underlying debt and ensuring sensitive information remains protected throughout the entire process.

This report examines the NPL industry landscape as businesses and economies slowly emerge from the COVID-19 crisis. We consider whether NPL trends after the 2008 financial crisis will inform the outlook post-COVID-19. We then review the new challenges in originating, marketing, assessing and

executing NPL transactions, and outline how virtual data rooms (VDRs) and innovative technology can enhance the entire NPL financing lifecycle.

The Market

The European market had more than USD 49 billion in the NPL pipeline in January 2019, and predicted little slowdown in supply, according to a 2019 report[4]. Comprising input from 103 corporate executives active in NPLs, the report found that 68 percent of financial institutions intended to bring an NPL portfolio to market, and 44 percent cited commercial credits as among their greatest challenges. Joint venture or synthetic transactions were preferred by 32 percent of sell-side institutions, and 24 percent of institutions preferred to handle their NPL portfolio internally.

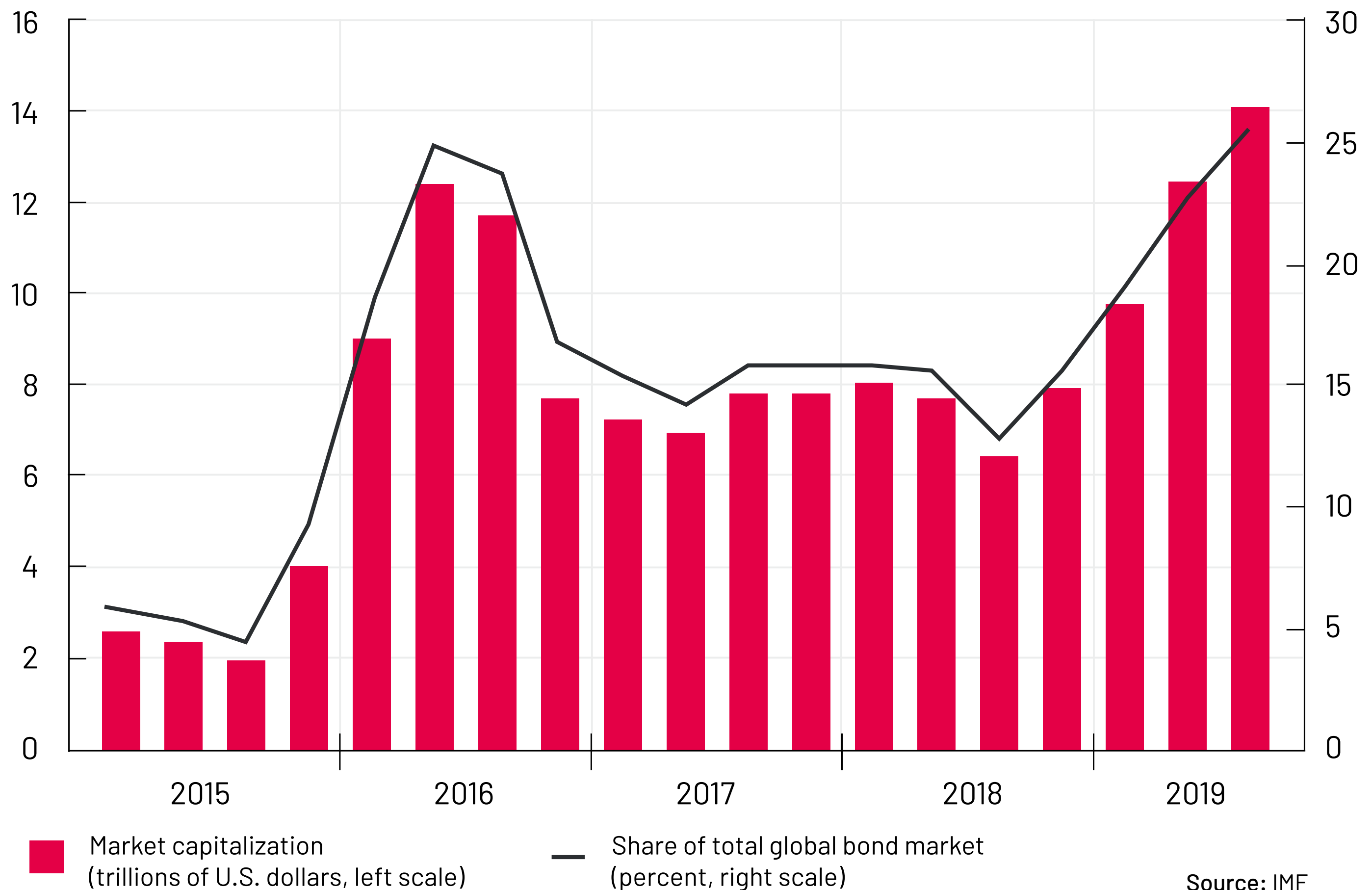
Italy, Spain and Greece had some of the highest levels of NPLs, with Italy at USD 113 billion; Spain at USD 47 billion; and Greece at more than USD 15 billion. In Portugal, where NPLs reached a high of USD 54 billion in 2016, banks reduced that to around USD 18 billion by the end of 2019.[5] China reached a ten-year high of CYN 3.4 trillion in the NPL market, which it characterizes as "lending at risk of becoming nonperforming," representing a 1.9 percent nonperforming loan ratio. Several private equity firms are purchasing these Chinese portfolios, but the deal size is in the millions compared with billions in European countries. India's nonperforming loans are on the rise, at USD 150.2 billion as of March 2018, an increase of INR 9 trillion in 2017. These data suggest that global investors will not lack for attractive NPLs portfolios and that sellers' assets are highly correlated with those that buyers hope to purchase.

Spread between governments and private entities, NPLs constitute as much as 7 percent of loans in 81 percent of 88 banking crises since 1980, according to the International Monetary Fund (IMF)[6]. In 30 percent of crises, NPLs exceed that figure for seven years after the banking crisis. COVID-19 is an event-driven crisis, rather than being financial in nature, but as countries struggle to deal with its fallout,

it is safe to assume that the rate of debt that becomes NPLs will spiral. Data collected by the IMF suggest institutional investors' increased appetite for risk, and the widespread nature of NPLs during economic crises.

Figure 1: Growth of negative-yielding bonds during periods of monetary easing

Market capitalization and share of negative-yielding global bonds (USD; %)



Source: IMF

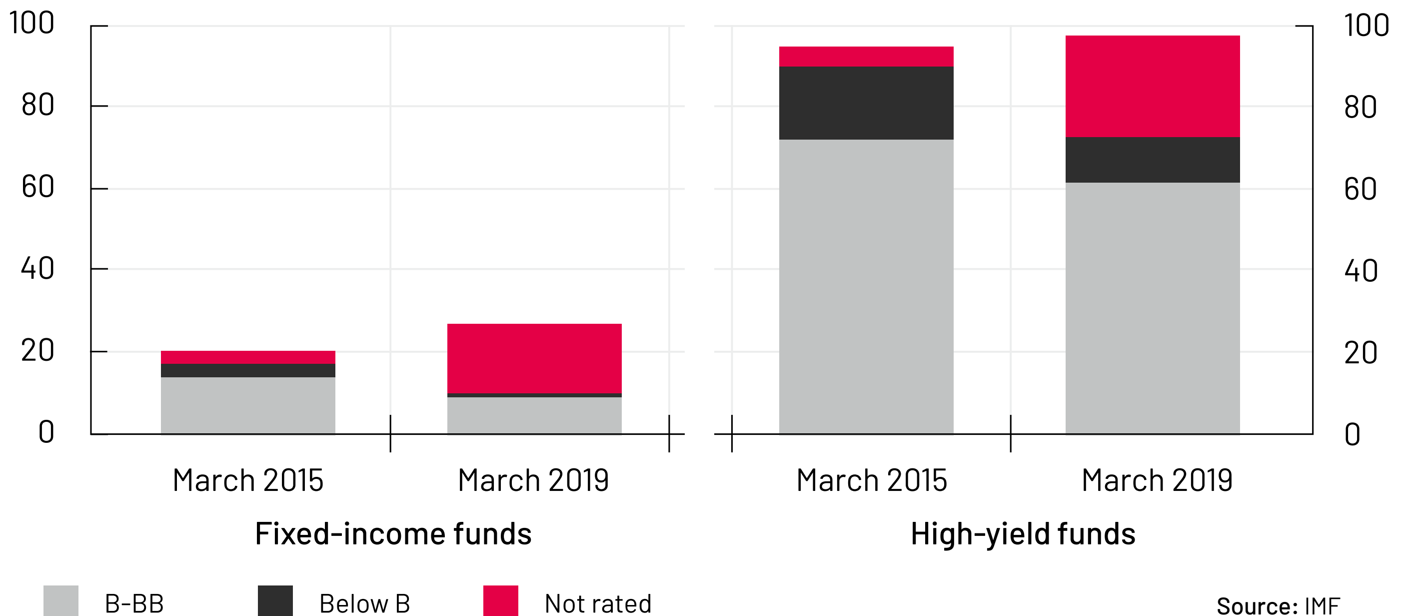
Liquidity injections, emergency business loans and grants, and government policy responses will not significantly stop the spike in non-performing assets and loans in 2020.

S&P Global Ratings[7]

Before the COVID-19 pandemic, vulnerabilities in the global financial system were becoming apparent, as the report by the IMF concludes. Corporations were incurring rising debt; institutional investors were increasing their holdings of riskier assets; and frontier and emerging economies were relying more upon on greater external borrowing to fund their growth. The search for yield had stretched asset prices and eased financial conditions in some markets, encouraging more risk-taking. Inflows of capital to risker markets supported more borrowing, in some areas as much as 300 percent of exports.

These sobering statistics could spell opportunity for investors, as NPLs play a vital role in portfolios as an income-producing, diversifying asset class. The investor's risk is offset by higher rates of interest, an attractive feature for institutions starved for income

Figure 2: In search of yield, fixed income funds increase holdings of lower-rated debt



Source: IMF

in today's low-interest-rate environment. And buyers of NPLs have a massive market available to them. The table below shows just how vast the debt market is in specific regions.

As the global economy struggles to cope with the repercussions of the COVID-19 crisis, investors will not lack for NPL deals. It will be especially challenging to determine the viability of, and thoroughly assess those opportunities. Investors will demand document accuracy before completing their purchase. For the seller or issuer, this affects all phases of the process, extending from deal origination through marketing, due diligence and post-sale and secondary market transactions. In the next section of this paper, we highlight some important considerations in the NPLs deal lifecycle, particularly relating to outreach to potential investors and assessment of the deal.

Figure 3: Global liabilities by type and region nearest USD billion; as of September 2019

	Total Debt	Banks/ Financial Debt	Non-Bank Debt	Unallocated Debt
Africa/Middle East	989	322	439	7.6
Europe/ Developing Europe	7,400	4,527	2,023	881.2
Asia-Pacific	1,656	1,074	565	17.6
United States[8]	40,200	1,678	673	4.2
Canada[9]	3,311	549	274	133.9

Source: Bank for International Settlements[10]

Marketing the transaction

Bringing an NPL opportunity to market involves mass outreach to an eligible investor base, and then tracking and focusing on those who indicate the most interest. The post-COVID-19 reality means more transaction components will need to be conducted remotely. Virtual tools will be required to distribute deal documentation efficiently, securely and on a broad scale; gauge potential investor interest by tracking and monitoring document views and downloads; and streamline outreach and follow-up, all while maintaining the security of information related to the transaction and all parties involved.

Preparation phase

Initial preparation includes sending teasers to generate interest. Once prospective investors show interest, non-disclosure agreements (NDAs) must be negotiated. Finally, offering memoranda is distributed. All of these steps can be managed through a virtual data room (VDR) to maintain control of documents and ensure each participant has an up-to-date and accurate version.

Sales cycle

As the sale process proceeds, closing the deal quickly and safely is the goal. Streamlining documentation and ensuring all participants have updated, reliable and accurate information improves efficiency — saving as much as 50 percent in time expended — and reduces execution risk at all stages of the process. Even more importantly, it guards against compliance risk by ensuring the legal team and regulators have access to the most current documents. Regulation is on the rise, witnessed by the European Central Bank's (ECB) announcement of an enhanced supervisory role for NPLs.[11]

Post-sale

Once the sale is completed, sellers are typically required to provide a mechanism for accessing post-sale documents for portfolio servicing and workouts, loan modifications or foreclosures. This can be accomplished by transferring information to a secure, virtual location for instant access, anytime, anywhere.

The post-COVID-19 reality means much of the transaction needs to be conducted remotely. Virtual tools will be necessary to conduct mass outreach to an eligible NPL investor base, track and focus on those who indicate the most interest, and much more.

Due Diligence

The predominant aim of due diligence is accuracy. Each deal participant will require that provisions important to them are included in the documentation to move the transaction forward. Questions arise that demand answers and a virtual platform can make responding a seamless process. That process enables the deal team to fast-track credit analysis and assess risk. At the same time, it keeps investors engaged, instilling confidence that all entities have the correct information they need for crucial decision-making. Alerts can be set up to send as soon as information is updated, which not only reduces the time to close but facilitates a smoother closing by maintaining a complete record of all documents and actions required. Keeping everyone involved in the process can prevent unexpected compliance and regulatory issues from derailing a deal at the last minute.

Protecting Sensitive Information

The rise in cloud-based SaaS technology underscores the need to protect sensitive information beyond ultra-secure technologies and VDRs. An informal survey conducted by Intralinks of typical deal stakeholders in a European market — investors, legal team, advisors, servicers and others — highlights the need to protect personally identifiable information (PII) and material nonpublic information (MNPI). These anecdotal survey results showed 40 percent of documents require protection, with an average of five different versions, totaling 50 thousand pages. Of the survey respondents, 81 percent reported delays in due diligence, requiring more than four days to redact. Approximately 38 percent of sellers and 34 percent of advisors surveyed engage with some form of PII, with 51 percent fearing reputational damage if it were not done correctly. Nearly all (94 percent) hope that artificial intelligence (AI) can soon expedite the redaction process.

The financial ramifications of MNPI and PII being compromised are legion. Insider trading and financial crimes have sent many executives and their employees to federal prison. Reputational damage has shaved

billions from corporations' stock value and driven customers to their competitors. Untold dollars in litigation and regulatory fines have pared bottom-line profits.

Data breaches are on the rise. In the first three quarters of 2019, 7.9 billion data records were exposed in the U.S. alone, causing the Federal Trade Commission to levy hefty fines.[12] Deal participants require add-on features to ensure the security and protection of PII and MNPI. Building an in-house solution takes time — a significant investment that delays deal completion when parties must move debt immediately. It also heightens the risk of error. Fortunately, readily deployable SaaS solutions can speed the process, reduce errors and improve efficiency.

Redaction

Regulatory authorities can impose significant monetary penalties if sellers fail to secure PII. For example, loss of trade secrets can expose sellers to legal actions. Redacting – removing, obscuring or covering text in documents before distribution – can mitigate such consequences. Performing this function manually is fraught with problems. Humans tend to tire, have difficulty staying focused and can miss important information. These slow, tedious processes can strain human resources, increase cost and force delays, all of which run counter to completing the transaction in a quick, accurate and cost-effective manner.[13] Fortunately, the technology exists to search and block predetermined sensitive information by centralizing the document review process and eliminating gaps in the workflow. It also can permit the unredacted document to an investor, when appropriate, at any point in the transaction timeline. AI is making great strides to identify commonly redacted items and find key terms across a secure VDR, replacing inefficient manual processes.

Information Rights Management

As companies rely more on the cloud for document storage, they run the risk of data leaks and security breaches. Examples of these abound: the most significant in October 2013, when hackers stole 153 million Adobe records, including customer names, IDs, passwords, and debit and credit card

data. EBay was close behind: A 2014 data breach exposed its entire account base of 145 million users to identity theft. When Marriott's Starwood Hotel brand was subject to a security breach, the crime was not discovered until 2018, giving the perpetrators two years of access to PII.[14]

Information rights management (IRM) uses embedded encryption to protect sensitive information, affording companies the freedom to share information while maintaining complete document control. Throughout the deal cycle, access to individual content can be granted and revoked, and documents can be created, viewed, edited and distributed, with settings and preferences embedded. A seller can revoke access at any time, ensuring security over intellectual property, and another feature ensures that document recipients are verified. IRM guarantees end-to-end, seamless content management at every stage of the deal — even for archived documents after the deal is done.

Watermarking

This is a technique of an owner embedding identifiable information to prevent copyrighted work from being used without permission. Doing so carries substantial penalties. NPL deal participants may prefer that a particular document version be limited and watermarked to ensure they are not misused or get into the wrong hands. Watermarking applies an electronic legend (for example, "confidential") and can be visible via a logo or text, or invisible, through embedding.

Conclusion

Debt capital markets are dramatically different post-COVID-19. With interest rates around the world hovering at zero, credit markets upended and defaults set to reach new highs — identifying, assessing, and investing in feasible opportunities will be critical for investors. And on the seller/issuer side — marketing the deal and delivering key information for due diligence will be essential.

There will be an overwhelming increase in NPLs as companies face challenges going forward. These challenges highlight the need for getting deals done rapidly to satisfy investors' appetite for income-producing

investments. Companies the world over will restructure their balance sheets in the face of mounting and crippling debt in their efforts to withstand the COVID-19 economic crisis, and investors seeking higher yields will be eager to purchase it.

Thorough due diligence, document accuracy and availability will be the mission in the critical months ahead. At the same time, facilitating these transactions via cloud-based solutions compounds the risk of data security breaches and compromising confidential information. NPL issuers and investors must seek the services of reputable, dependable and extremely secure document sharing providers.

About SS&C Intralinks

SS&C Intralinks is an industry leader in virtual data rooms (VDRs) and secure document exchange, offering a platform that supports the full NPL sales process. 99% of the Fortune 1000 have executed more than USD 35 trillion of financial transactions using our VDR technology. With Intralinks for NPLs, deal teams can execute deals faster and more intelligently, while minimizing execution and compliance risk.

Contact us to learn more about how Intralinks can help your organization manage the sale of NPLs and close deals faster.

References

[1] CNBC, November 2019

[2] Investopedia

[3] S&P Global Ratings, April 2020

[4] Ashurst and Debtwire, March 2019

[5] Reuters, April 22 2020

[6} International Monetary Fund, October 2019

[7] S&P Global Ratings

[8] Bank for International Settlements

[9] Bank for International Settlements

[10] Bank for International Settlements

[11] KPMG

[12] Identity Force

[13] Deloitte

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Navigate the post-pandemic NPL market faster and smarter.

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