



# Opportunities in the Portuguese NPL Market



MACEDO VITORINO & ASSOCIADOS  
Sociedade de Advogados, RL

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# Introduction

Despite the improvement of Portugal's economic conditions and the reduction of the historically high levels of non-performing loans, the renewal of the efforts to continue deleveraging the economy may prove essential to face the next economic crisis.

Looking in retrospect the causes of this crisis are clear: the slow growth of the economy, the excessive weight of the State and the high levels of public debt, corporate debt and individuals' debt.

These factors combined with the global financial crisis of 2008 triggered a serious financial and economic crisis, which would culminate in the request for international aid in 2011.

Presently, seven years after the beginning of the bailout program and four years after its end, the amount of Portuguese NPLs remains high despite the reorganisation of the banking sector and the steps taken to deleverage the economy.

In the wake of the European bank crisis fuelled by the Greek, Irish, Portuguese and Cyprus bailouts, the European banking authorities imposed more stringent stress tests on banks, ordered the strengthening of banks' own funds and the contribution of shareholders and creditors for the recapitalisation of distressed banks.

However, the European bank resolution mechanisms do not respond to the apparently less critical situations where imbalances result from the difficulties in disposing of non-performing loans, which can become more serious when they reduce the liquidity of banking institutions and undermine the confidence of depositors.

As a result, public and private indebtedness in Portugal and in other European countries remains high and non-performing loans still weight heavily on banks' balance sheets.

The Portuguese government and international institutions, like the IMF, the OECD, the European Commission, the EBA and the ECB recognize the problem and agree that banks should be freed of non-performing loans. However, they do not agree on the urgency of the problem and on whether State and/or European intervention are needed. While the EBA, the IMF and the OECD have been advocating the creation of an European mechanism for the disposal of bad loans, the EU Commission and the ECB prefer a softer approach.

# €14,888 million

## Volume of non-performing loans in Q2 2018

In 2011, the sovereign debt crisis put a spotlight on the excessive indebtedness levels of the Portuguese economy as a whole. The debt of families, corporations and the government had reached a staggering amount of 432% of Portugal's gross domestic product.

From 2011 to 2018, the total debt of families and companies decreased from 255% of GDP to 205.5% as a result of a contraction in the loans extended by banks of €75,800 million, including €33,300 million in the loans to families and €42,500 million in corporate loans.

	2013	2014	2015	2016	2017	2018 (Q2)
Total financial debt of non-financial companies (% of GDP)	163.3%	155.8%	147.5%	139.8%	135.6%	133%
Loans provided by banks operating in Portugal to non-financial companies (annual change)	-5.7%	-4.7%	-2.1%	-2.8%	-3.3%	-1.6%
NPLs of non-financial companies (% of total loans to non-financial companies)	13.4%	15.0%	15.5%	15.2%	13.5%	12.6%
Total non-performing loans	€18,477	€19,446	€19,246	€17,524	€15,838	€14,888

Source: Bank of Portugal (amounts in € mln)

The deleveraging of Portuguese banks, corporations and the economy as a whole is far from complete. The rate of corporate NPLs still represents 12.6% of all corporate loans, despite its decrease from the historic high of 15.5% in 2015 and the reduction of corporate debt from its peak of 163% of GDP in 2013 to 133% in 2018.

The high levels of the overall amount of NPLs, presently €14,888 million, poses issues for banks and their shareholders, which face increasing capital demands, and hinders the prospects of many viable companies and the economy as a whole, which remain overburdened with unpayable debts and cannot reach their true growth potential.

# Why banks do not resolve their NPL backlog

In 2017 bad loans recognised by banks accounted for 13.5% of all corporate loans and 4.8% of all loans to individuals, which compares to 13.4% for companies and 4.4% for individuals in 2013.

The total value of troubled loans in the second quarter of 2018 of €14,888 million remains a burden on banks and the economy as a whole despite the steep reduction in relation its peak of €19,446 million in 2014.

According to the World Bank, in 2017 Portugal had the fourth highest non performing loan rate (as a percentage of the total credit) in Europe, only behind Greece, Cyprus and Italy.

In its September 2018 post-program monitoring report on the Portuguese economy, the IMF highlighted that the resilience of the banks improved significantly in 2017 as consequence of rising capital ratios, falling rates of non-performing loans and lower impairments. Portuguese banks adopted various measures that made them more resilient, but these may still not be enough to prepare them for the next economic downturn.

The backlog of non-performing corporate loans remains high because it has been difficult for banks and investors to find a balance between the banks' price expectations and the buyers' valuation of the assets.

This gap persists due to the following factors:

- The tax and accounting impact of a sale of assets below their balance sheet value;
- Banks' expectations of a future valuation of unprofitable assets which undermines investors' return requirements; and
- The lack of incentives and pressure from regulators for banks to sell troubled assets.

To bridge this gap banks and investors must change their approach to potential deals.

# An European problem?

The Portuguese NPL problem is akin to that of several European countries, such as Italy, Greece, Ireland and Cyprus. According to the ECB, in the first quarter of 2018, the volume of bad loans in the European Union amounted to €688,000 million, despite the reduction of the NPL rate from 5.90% in Q1 2017 to 4.81% Q1 2018.

The high levels of non-performing loans in some European countries have led international institutions to advocate the creation of public and private vehicles for the management of bad loans. The EBA proposed a roadmap leading to the creation of an European asset management company to acquire non-performing loans.

The European Commission proposed the harmonisation of the legal framework regarding the treatment of non-performing loans and insolvency regimes in Europe to facilitate the creation of a secondary market. However, the European Commission lacks the conviction to force banks to sell non-performing loans.

The ECB has also rejected to play a more central role in the solution of the problem and argues that it is up to the governments to change the legal and judicial framework of each country to facilitate the reduction of bad loans. The ECB is against a centralised European solution and prefers a gradual and decentralised solution. The ECB recommends that credit institutions implement realistic and ambitious strategies with a view to developing a "holistic" approach, including areas such as governance and risk management, which should ensure that managers are encouraged to reduce banks' backlog of non-performing loans.

However, the ECB does not set quantitative targets for the reduction of non-performing loans that could serve as an incentive for national authorities to take a more proactive role in resolving the problem.

The soft approaches of the European Commission and the ECB show the lack of support from countries, such as Germany, that do not face high levels of NPLs and have no interest in an European solution.

Although the creation of an European asset management vehicle for NPLs with the recourse to EU funding is not essential, the lack of European mechanisms that promote an uniform approach to the problem of bad loans inhibits national governments from taking stronger steps, including incentives and penalties to force banks to sell troubled assets.

# The Portuguese government's response

When the Portuguese government took office in 2015, it advocated that urgent and resolute actions for cleaning-up banks balance sheets were needed and that the creation of a government supported "bad bank" to free banks from non-performing loans.

This position contrasted with the position of the previous government, which believed that, as the economy improved, banks would be able to solve the problem on their own by selling bad loans and strengthening their capital structure.

Meanwhile, the government abandoned the idea of creating a bad bank and reverted to the previous government's belief that the system has the tools to solve the problem on its own.

There are several reasons for the government's change in position:

- Firstly, a significant part of bad loans has been recognised by banks as impairments and provisioned for and/or covered by guarantees, which limits the problem of non-performing loans to an amount between €15,000 million and €20,000 million;
- Secondly, banks have access to the liquidity made available by the ECB and the market which gives banks the means to continue financing the economy;
- Thirdly, the creation of a bad bank could be considered by the European Commission as State aid, which would prevent the government from giving financial support, even in the form of a State guarantee. As a result, transfers of non-performing loans would have to be priced at market value, which is presently below the value recorded in the banks' balance sheets, triggering additional losses and the need for new capital;
- Fourthly, any potential restructuring/recovery of bad loans would ultimately benefit investors and not the banks.

To reduce the levels of NPLs, the government improved the legal framework to speed up corporate restructurings and proposed the creation of private, voluntary and non-exclusive management companies to manage corporate NPLs, which led to the creation of the "Plataforma" for the management of the more problematic assets of three of Portugal's largest banks: CGD, Millenniumbcp and Novo Banco.

# A step in the right direction?

The Portuguese government's response fell short on its early promises. To achieve an effective reduction of banks' troubled assets, banks and investors must be lead to agree on the price of the assets. The creation of privately owned asset management companies can be a step in the right direction, but it does not ensure an effective resolution of the problem, as it is dependent on the adherence of banks.

The government's response also did not solve the problem of indebted companies, which continue burdened by high debt levels (except when banks and/or the asset management companies decide to ease the debt burden) instead of incentivising speedy restructurings and the equitization of debts.

In many cases, the creation of bank-owned asset management companies may serve to postpone recognising impairments and may not prevent or reduce banks' losses, as experience shows that banks have, in the past, exhausted the resources of viable companies in weary and protracted corporate restructurings and allowed many non-viable companies to continue trading.

To effectively reduce the volume of non-performing loans, banks must dispose of bad loans, which will only occur if they are incentivised to do so and penalised if they do not.

For asset management companies to effectively contribute to the reduction of the banks' NPL backlog, they must be independent from banks as regards the appointment of their managers and in the decision taking process in relation to the assets that they may acquire.

Management companies may be successful in reducing banks' non-performing loans, but this should not be used to avoid taking difficult measures and recognising losses. Therefore, the remuneration structure cannot be dependent on the volume of assets under management and should reward the results obtained, which should include the recovery rate as well as the speed restructured debtors are put back in the market.

Management companies' decision taking process regarding the acquisition, management and disposal of assets must be market driven.



# A solution for Portuguese NPLs

The current situation calls for a determined action to promote the deleveraging of the Portuguese banking system as a means to avoid future crises and reduce potential risks to taxpayers and depositors of being called to bailout banks.

International experience shows that troubled assets purchase programs backed by public money can be successful if banks are required to sell the assets to independent investors and retain no prerogatives regarding the management of the assets.

To be successful, any program supported by taxpayers money should be based on four pillars:

- First, the measures adopted should be definitive. The solution should aim to bring closure to the problem and not serve to park the assets. Any State intervention should ensure that the relationship between the banks and the troubled assets is severed, so that viable companies may be restructured and freed of their debts and those that are not viable are liquidated;
- Second, the solution should be balanced, *i.e.* the proposed measures should be sufficiently strong to make banks dispose of their distressed assets without imposing excessive and punitive costs on them and/or on their shareholders;
- Third, the solution should be neutral. A State intervention cannot cause distortions in competition or on the relative position of banks in the market, benefiting some in detriment of others;
- Finally, the intervention should not entail costs for taxpayers.

Asset management companies could be financed by the banks, by their shareholders and/or by private investors, provided that they act independently from the originating banks.

The State could provide guarantees or contribute funds to ensure that the price gap can be bridged, but this intervention cannot entail the transfer of losses to the taxpayers. Any future losses should be absorbed by banks and private investors.

# Looking forward

The latest developments show that the intention of creating a public program for the purchase of non-performing loans, in the form of a bad bank or other, lost its momentum.

In the absence of a public intervention program, it is up to banks and private investors to bridge the buy-sell price gap. This gap results from the belief of banks selling non-performing loans that the assets' valuation will improve in the future.

However, this will hardly happen if the management of the assets is entrusted to management companies created, owned and controlled by the banks, which are more interested in preserving the assets than in improving their value.

Private investors mistrust the bank's valuation of corporate NPLs available for sale and fear that the recovery potential of the assets in contrast with the sellers' ask price will not generate the desired returns for the level of risk they are assuming.

The market for the purchase of non-performing loans of companies in distress is not a liquid market; in other words, in the distressed companies' market, each asset has its own value which, in many cases, cannot easily be compared with other similar domestic or foreign companies. As a result, it is more difficult to use the same selling or buying strategy that is used for selling or buying other non-performing loans, such as non-performing consumer loans and residential mortgages.

Therefore, the approach to opportunities in the corporate NPL market must be made on case-by-case basis. Each deal must be supported by a legal, financial and operational due diligence on each asset and by a credible recovery strategy, which may involve taking control or liquidating the asset.

The specificities of non-performing corporate loans make it difficult, in many cases, for sellers and buyers to reach an agreement on the right value for the asset and on the expected recovery rate.

The differences in the expectations of buyers and sellers can be bridged through partnerships that generate interesting returns to reward the buyers' investment and give the sellers some of the upside on a future sale/recovery of the assets.

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