Matters relating to the Resolution, including Sale, of Non-performing Loans (NPLs) and Private Investment Funds

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By Dr Martha O'Hagan Luff, Assistant Professor of Finance, Trinity Business School.

An overview of the role, functions, structures and operations of Private Investment Funds

A Private Investment or Equity Fund is an investment company that raises capital only from qualified and accredited investors, and does not solicit capital from retail investors or the general public. The regulatory and legal requirements are much lower than what is required for funds that are traded publicly. This gives the funds more freedom in how they handle elements of their business from reporting requirement to redemptions.

Private Investment Funds have a very different business model to that used in retail banking. Their time horizon for return on investment is relatively short, often as little as two to three years, but sometimes longer, and they seek higher short-term returns, in contrast to the lower longer term returns sought by retail banks.

The role played by Private Equity Funds in an Irish context and their impact in terms of the acquisition of loan portfolios;

Several loan sales have already taken place in the Irish market, for example Lone Star securitised mortgage loans originated by Irish Nationwide Building Society, while Oaktree affiliate Mars Capital securitised loans from INBS and Permanent TSB in 2016. Nama sold a substantial portion of its portfolio to private investors, and the liquidation of IBRC resulted in a large volume of loan sales. Previous sales included commercial property loans, business loans, buy-to-let mortgages and residential mortgages. AIB has recently drawn bids for a portfolio of commercial property loans and buy-to-let mortgages from Goldman Sachs, Lone Star, Cerberus and Pimco. Ulster Bank, Danske Bank, Bank of Scotland Ireland and PTSB have also announced plans for NPL sales. To date, private funds have bought around 11,000 loans of family homes, 1.5% of the existing mortgages in the State.

A comparative context as to how Private Equity Firms operate in jurisdictions vis-a-vis Ireland

The IMF reports (*A Strategy for Resolving Europe's Problem Loans*: Sep 2015, IMF) that the market for sales of distressed debt in Europe is underdeveloped and focuses mainly on commercial real estate and consumer loans. At the end of 2013, the market value of distressed debt transactions in Europe was only €64 billion compared with close to €400 billion in the United States, despite a stock of NPLs several times bigger than the United States. Volumes are increasing, for example in Italy (increased from €5bn in 2013 to €20bn in 2016), but the sale of NPLs on the secondary market remains underdeveloped.

The reasons for the low volume of sales are reported by the IMF as; incomplete credit information on borrowers, regulatory frameworks where non-banks are not allowed to purchase and manage NPLs, overvalued collateral and lack of liquid real estate markets, low recovery values due to lengthy court procedures and inadequate provisioning of NPLs. However, some of these constraints are changing. For example, at the end of 2015 Greece passed a law facilitating the sale of NPL portfolios to non-bank companies. The law provides that NPL asset management companies will be allowed take over NPLs under minimum registration requirements, provided borrowers have been duly notified.

The regulatory and prudential requirements that govern the operation of private investment/equity funds and the safeguards in place to protect both investors and mortgagees whose loans have been purchased by such funds.

Many private investment firms are unregulated and would therefore not fall under the remit of the Central's Banks regulations. Ireland introduced legislation in 2015 to protect borrowers (individual and SMEs but not corporates) whose loans are sold to unregulated entities. If an unregulated firm buys loans from an original lender, the loans must be serviced by a 'credit servicing firm' which must be authorized and regulated by the Central Bank. Loans held in the credit-servicing firm are afforded the same regulatory protections under the Credit Servicing Act; the Code of Conduct on Mortgage Arrears, the Consumer Protection Code, and SME Regulations. The legislation does not directly regulate loan purchasers but those firms servicing (managing and administering) loan agreements on behalf of purchasers so as not to discourage loan sales.

The "pros" and "cons" of the activities of Private Investment Funds with specific reference to how they may assist in dealing with the high-level of non-performing loans (NPLs) within Irish Banks as part of the EU Direction that banks reduce NPL levels.

NPL ratios in Irish Banks: The 2008 Financial Crisis resulted in a rapid increase in NPLs in Ireland, and remains as one of the primary sources of vulnerability facing the domestic banking system. Despite €74bn of large commercial real estate loans transferred to Nama in 2009, Irish banks had a further €80 billion of NPLs in 2013 that has since reduced to €34 billion as of September 2017. Ireland's banks' NPL ratio has reduced significantly from its peak of 32% in 2013, down to 15% in 2016 and to 11% in 2017. However, the European average of 4.6%, means it is still one of the highest in Europe. The Irish and European regulator have recommended that the NPL ratios for Irish banks be further reduced. NPLs constitute a drag on economic activity, reducing profitability, increasing funding costs and tying up bank capital, which negatively impact credit supply, borrowing rates and ultimately economic growth. Furthermore, it has been found that, countries with higher NPLs tend to have lower credit to GDP ratios, lower growth and higher unemployment. Many measures have been implemented in Ireland to reduce NPL ratios such as debt restructuring, voluntary or involuntary repossession, mortgage to rent schemes and sales of distressed loans.

The following points outline the benefits and risks of selling portfolios of distressed mortgages to private investment funds, as well as some recommendations.

Pros

- Allowing the sale of distressed loans portfolios to private investment funds may facilitate debt restructuring to be done more actively and efficiently.
- Private funds will have greater flexibility in the resolution of NPLs. In the case of a renegotiated loan involving the voluntary surrender of a property, funds will have greater flexibility to allow debt forgiveness on the outstanding loan which is very difficult for banks to do given the moral hazard issues which would arise with other customers. In this scenario customers may be able to negotiate a *better* deal with a fund than they would be able to with a bank.
- Private Funds can offer badly needed liquidity to banks for NPLs that is not otherwise available.

Cons

- Assets may be sold at too low a price. Sales can occur as 'firesale' prices in a crisis but we are no longer in the midst of a crisis so this is less of a risk, rather it will depend on how much liquidity exists in the market. This will be for banks to negotiate.

- There are concerns around consumer protection. As the private investment funds are unregulated they do not fall under the remit of the Central Bank. However, if loans are sold they must be serviced by a 'credit servicing firm' which will be authorized and regulated by the Central Bank, and subject to the same consumer protection legislation as banks.
- Even when codes of conduct are adhered to, there may be reputational risk issues for the banks if funds are perceived to act aggressively or unreasonably with their former customers.
- There is a potential risk of an increase in forced repossessions, although there has been little evidence to support this so far. Research by UCC economist Séamus Coffey has shown that the rate of repossessions of family homes and buy-to-lets in Ireland is extremely low compared to our EU counterparts, including repossession of loans held by the non-regulated funds. At the time of his analysis he found that only 15 per cent of repossession cases listed in the courts had been taken by private funds, and that between 2010 and 2015, only 1.4% of mortgages had been repossessed in the state.

Concluding Comments

In summary, while it is essential that the most vulnerable in our society are protected through schemes such as the mortgage to rent scheme, and that high standards of consumer protection are ensured, there are substantial risks of not resolving the NPL issue. It delays the resolution of non-performing loans with borrowers. It creates an issue of moral hazard around mortgage repayments, creating a situation where there is less incentive for current and future borrowers to abide by the terms of a contract if the contract is unlikely to be enforced. Secured lending is not secured in reality if repossession continues to be such a lengthy and difficult process, and risks creating a dysfunctional mortgage market. This could lead to a lower supply of mortgage credit, and higher interest rates than would otherwise be the case for the market as a whole in the future.