



cutting through complexity

LOAN PORTFOLIO ADVISORY

Global Debt Sales survey 2012

Portfolio Solutions Group

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KPMG INTERNATIONAL



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Foreword

Global debt has seldom generated as many headlines or been as central to the world's economic prospects as it is in 2012 – and rarely has the market for global debt been as volatile or as complex, with Europe in the midst of a major economic malaise.

The woes in the Eurozone, which in May saw policymakers finally begin to talk publicly about the possibility of a Greek exit from the Euro, have deepened. Banks in Italy and Spain have been downgraded by ratings agency Moody's Investor Services (Moody's), while Spain announced a raft of measures, including independent, third-party valuation of existing loan books, to force banks to quantify the extent of potential future losses that have been concerning the financial markets. The recent public insistence by the China Banking Regulatory Committee is that the country's local government debt (estimated at US\$1.7 trillion at the end of 2010) is under control. Fitch Ratings decision to downgrade Japan's sovereign rating to A+, with the country's debt load rising above 200 percent of annual gross domestic product,¹ are proof that few of the world's major economies are free from worries about debt.

Since we last published our comprehensive second edition of Global Debt Sales in September 2011, the European Central Bank has taken steps to prop up the banking system with over EUR1 trillion of additional liquidity. The ECB move was designed to encourage banks to provide loans to companies and consumers and has, the ECB insists, led to increased liquidity. But much of the money has found its way back into the hands of sovereign governments, who have benefited from the region's banks engaging in a profitable carry trade, taking ECB money at 50 basis points and lending it back to governments at up to 600 basis points or even higher for some of Europe's more troubled economies. This trade has been driven by the desire of European banks to strengthen their capital ratios as required under Basel III with a follow-on impact of reducing the pressure on banks to reduce Risk Weighted Assets (RWAs) through the disposal of non-core assets, including businesses and debt portfolios.

In terms of asset disposals by banks, despite over EUR1.5 trillion of NPLs sitting on European banks' balance sheets, constraints in the global funding



Graham Martin
Global Co-Leader,
KPMG's Portfolio
Solutions Group



Stuart King
Global Co-Leader,
KPMG's Portfolio
Solutions Group

€1trn

*The amount in cheap money
the ECB has pumped into
Europe's banking system*

¹ Wall Street Journal, 23 May 2012

■■■ The questionnaire has confirmed our belief that misalignment between buyer and seller expectations on risks and opportunities exists – but they are getting closer.■■■

Graham Martin, Global Co-Leader, KPMG's Portfolio Solutions Group

market, the preference of banks to preserve capital rather than expand and acquire the underlying quality of certain bank assets and loans, has meant that a 'wave' of deleveraging transactions is yet to materialize. This – as we will show – will change. While this is likely to change in time, differences remain between what sellers want, and what buyers are prepared to pay.

We have conducted an extensive survey of more than 50 buyers and sellers in some of the key debt sales markets – Spain, Germany, the UK and the US. We targeted buyers of loan portfolios, including strategic buyers, private equity funds, investment banks, and opportunity funds, as well as sellers, including commercial banks and other financial institutions. These institutions have been active buyers and sellers of debt portfolios, having completed a wide range of transactions in different geographies and classes of assets. We thank them all for their participation in the survey.

With extensive experience advising sellers and buyers on hundreds of loan mandates globally, KPMG's global Portfolio Solutions Group is a senior team of loan portfolio professionals from across the KPMG global network, that works alongside government and financial institutions, private companies, strategic and financial investors, debt collection agencies, industry financiers and other professionals to understand the specific issues facing each market. Aside from our traditional lead sell-side and buy-side mandates, our banking clients are asking us to assist them to understand the market pricing they can expect from potential debt purchasers prior to approaching the market. This is an important first step in countries and asset classes where no secondary markets for portfolios has previously existed.

We hope to once again share some insight with our readers to help market participants cut through the complexity of global debt sales and maximize the value of their loan portfolio positions. We encourage you to contact the authors or your local KPMG member firm to discuss the findings in more detail and to register your interest in the next survey.

Graham Martin

Global Co-Leader, KPMG's Portfolio Solutions Group

€1.5trn

The amount of NPLs on European banks' balance sheets

Market overview

LTROs

Cheap ECB money has strengthened banks' balance sheets in the short to medium term, allowing some to delay asset sales and prolong restructuring negotiations.

Price expectations

For varying reasons, a bid-ask spread remains in most markets and across most asset classes, however these spreads are narrowing.

Leverage

Third-party banks are increasingly willing to provide funding to buyers, often through financing packages, though vendor finance remains the exception rather than the rule.

New entrants

A number of new players have entered the debt purchasing markets, most notably key US funds and banks seeking acquisition opportunities in Europe, particularly in the CRE and consumer NPL space.

Tenor, yield and credit quality, alongside the availability of funding, are driving interest and pricing for performing loan portfolio sales, which has led to longer term investors such as pension funds and insurers becoming buyers of bank loans.

Basel III

In order to improve capital ratios and rightsize their balance sheets, European banks could shrink their balance sheets by US\$2.6 trillion through to the end of 2013, which is likely to be a key driver of deleveraging.

Over €1.5 trillion of NPLs sitting on European banks balance sheets with over EUR600 billion in the UK, Spain and Ireland alone.

9%

Core Tier 1 capital ratio banks must adhere to Basel III

Basel III

Increasing Tier 1 capital or decreasing RWAs?

The key elements include:

- increased capital ratios, with a focus on the need for good quality, loss-absorbing equity capital
- increasing quality of capital requirements with a focus on harmonization across borders
- new leverage requirements, effectively capping the absolute size of balance sheets in relation to capital, irrespective of risk
- new measures to improve counterparty risk management, focused on collateral management and stress testing
- new liquidity requirements to ensure firms hold sufficient high quality liquid assets to meet short-term shocks, and to encourage a restructuring of the balance sheet with a focus on matching of long-term funding sources against longer-term assets.

With international capital markets effectively closed to new share issuances and muted bank profitability, achieving the higher Tier 1 ratio thresholds will be assisted through RWA reduction. The conditions are ripe for a considerable increase in the volume of deleveraging around the world, but the urgency is greatest in Europe. Bank restructuring continues apace and the deadline for banks to have a core Tier 1 capital ratio of 9 percent under Basel III is fast approaching (see: Basel III: Increasing Tier 1 capital or decreasing RWAs?, above). The International Monetary Fund's (IMF) latest Global Financial Stability Report suggests that large EU-based banks could shrink their combined balance sheet by as much as US\$2.6 trillion through end-2013, or almost 7 percent of total assets. "Our estimate is that about one-fourth of this deleveraging could occur through a reduction in lending, with the remainder coming largely from sales of securities and non-core assets," the IMF said.²

Achieving the targets of Basel III is by no means assured. Morgan Stanley estimates that 11 of the 30 largest banks in Europe will not reach the required 9 percent threshold by 2013, including Deutsche Bank, Credit Agricole, Unicredit and Lloyds Banking Group.³ The bank noted that a deteriorating earnings outlook for European banks means that banks will have more challenging organic capital builds to reach new capital ratios.

"The European market has seen some notable transactions such as Project Isobel, in which the Royal Bank of Scotland reportedly sold a 25 percent interest in a GBP1.36 billion portfolio of loans to Blackstone. In a transaction that also closed in December 2011, Project Royal, Lloyds Banking Group sold GBP900 million of non-performing loans to Lone Star.⁴ But despite these headline-grabbing deals, the market has not taken off to the extent that many participants expected," says Stuart King, Global Co-Leader, KPMG's Portfolio Solutions Group.

2 IMF Global Financial Stability Report –The Quest for Lasting Stability, April 2012

3 Morgan Stanley: European banks: What are the risks of €1.5-2.5trn deleveraging?, November 2011

4 CoStar News, December 7 2011, <http://www.costar.co.uk/en/assets/news/2011/December/Lone-Star-wins-1bn-Project-Royal/>

Are LTROs a brake on sales?

This is due in part to the EUR1 trillion of long-term refinancing operations (LTROs) the European Central Bank (ECB) has pumped into the banking system. In a move of unprecedented scale, the ECB injected EUR489 billion of cheap money on 21 December 2011 and a further EUR530 billion on 29 February 2012. This long-term refinancing of banks had an exceptionally long maturity of three years (prior issues were matured within 18 months), with an option of early repayment after one year as a fixed-rate tender at full allotment (see graphs, page 10).

Europe's banks gratefully accepted the cheap money – priced at 50 basis points for three years – and initially deposited the funds with the ECB. Some banks have also used parts of the LTRO allocation to acquire sovereign debt, having the dual effect of pushing down sovereign debt yields and boosting bank profits through the spread created on the carry trade.

"There is a general view that LTROs have reduced the urgency of asset sales in the short term," says Nick Colman, Director in the Portfolio Solutions Group at KPMG in Germany. "This may be the case for the very large portfolios of long dated residential mortgages and project finance loans that they have sitting on their balance sheets, but we see a lot of sale activity for stressed and NPL portfolios which are expensive from a capital perspective and where value leakage for the bank is a key concern."

LTROs were designed to stimulate bank lending to corporations and



€103bn

Amount released to Europe's banks when ECB lowered its minimum reserve ratio from 2% to 1%



households and the ECB is claiming some success in this regard. This is supported by the Bank Lending Survey (produced by the ECB) results for the first quarter of 2012, which indicated a substantial reduction in the rate at which European banks have been tightening their credit standards. Loans to non-financial corporations declined to 9 percent in net terms, from 35 percent in the fourth quarter of 2011, and for loans to households for house purchase, they fell to 17 percent from 29 percent in the preceding quarter and for consumer credit, to 5 percent from 13 percent. "This drop was much more pronounced than anticipated by survey participants at the time of the previous survey round and mainly reflected milder pressures from cost of funds and balance sheet constraints, in particular as regard banks' access to funding and their liquidity position," the BLS report said.⁵

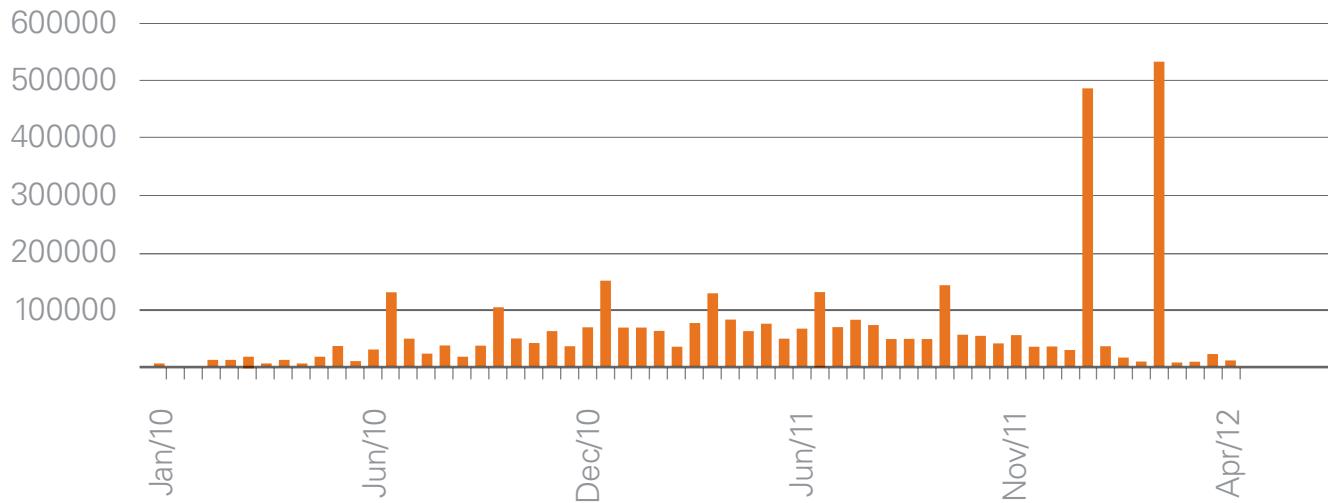
Some critics have questioned whether LTROs are having some unintended consequences. A European Parliament report cautioned that: "The ECB is delaying the restructuring efforts of several commercial banks in the Southern Euro area and, thus, prolonging the existence of a couple of non-viable banks."⁶

5 European Central Bank, Bank Lending Survey, April 2012

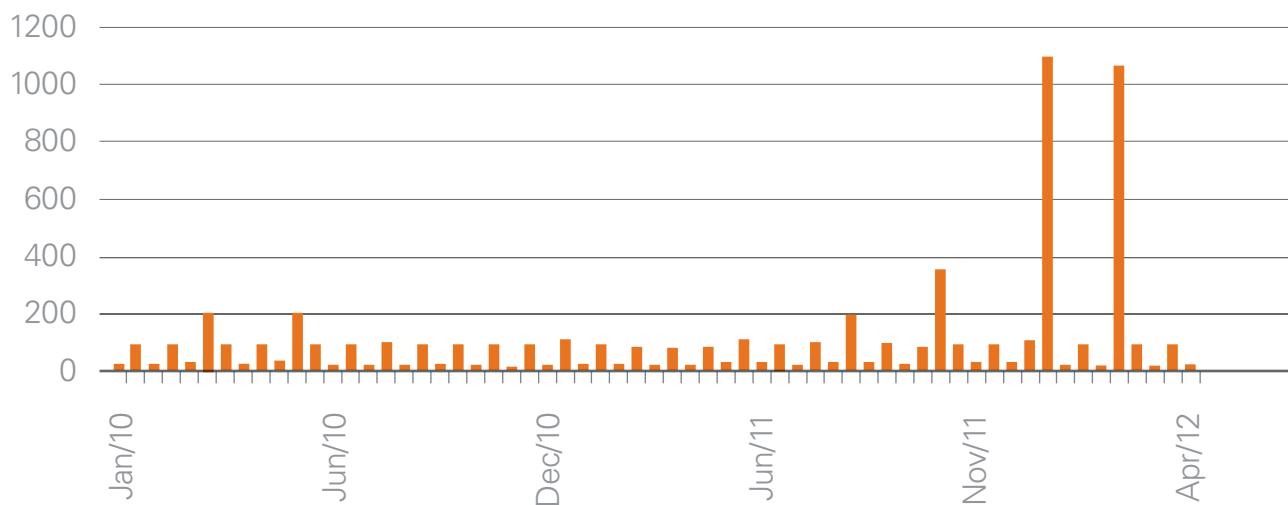
6 European Parliament, 3-Year LTROs – A First Assessment of a Non-Standard Policy Measure, April 2012

LTRO size and maturities

LTRO size (€ m)



LTRO maturities (days)



Source: European Parliament, 3-Year LTROs – A First Assessment of a Non-Standard Policy Measure, April 2012

■■■ We see a lot of sale activity for stressed and NPL portfolios which are expensive from a capital perspective and where value leakage for the bank is a key concern. ■■■

Nick Colman, Director, Portfolio Solutions Group, KPMG in Germany

Spain is the hottest distressed debt market right now – the pipeline is considerable. We would expect to see EUR10 to 15 billion of transactions in the next 12 months.

Joel Eduard Grau Blasi, Director, Portfolio Solutions Group, KPMG in Spain

Banks' creditworthiness questioned

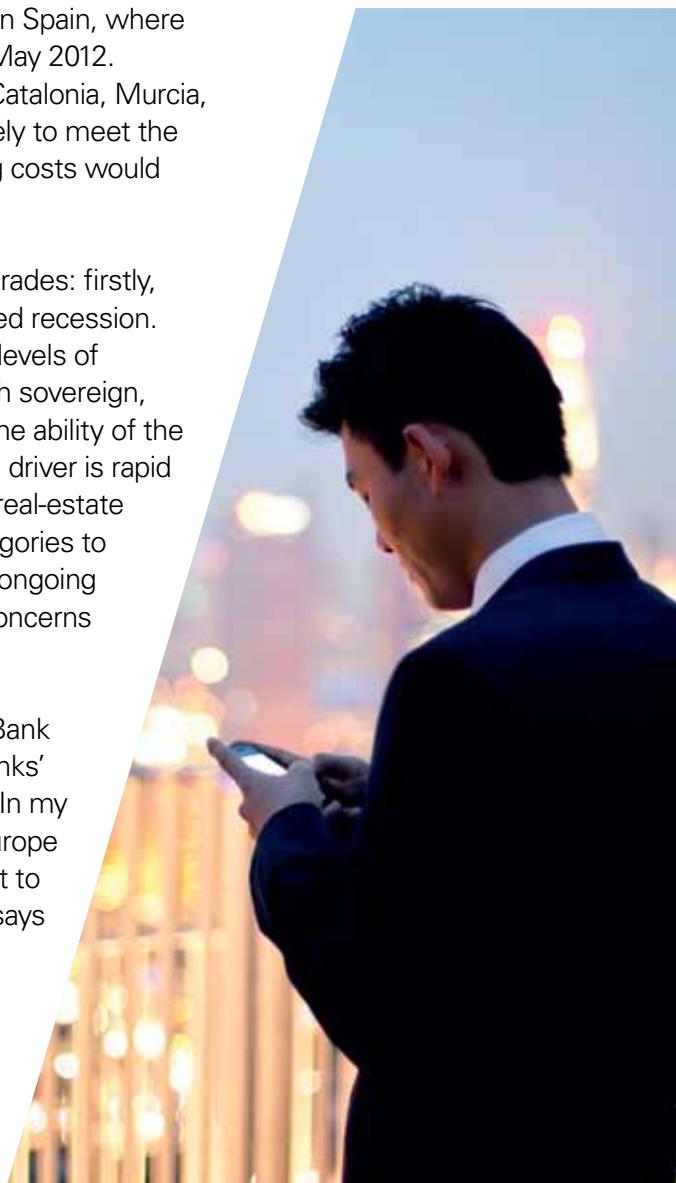
More recently, the viability of banks has come to a head in Spain, where Moody's cut the ratings of sixteen Spanish banks on 17 May 2012.

Moody's also cut the ratings of four of Spain's regions – Catalonia, Murcia, Andalusia and Extremadura – saying they would be unlikely to meet the 2012 deficit target. Moody's warned that rising borrowing costs would reduce Spain's ability to provide support for its banks.

Moody's said there were four main drivers for the downgrades: firstly, adverse operating conditions characterized by the renewed recession. Next is the ongoing real-estate crisis and persistent high levels of unemployment. Reduced creditworthiness of the Spanish sovereign, which weighs on banks' standalone profiles and affects the ability of the government to support banks, is a further factor. The final driver is rapid asset-quality deterioration, with non-performing loans to real-estate companies rising quickly. Moody's expect other loan categories to deteriorate; and restrict market-funding access, with the ongoing Euro area debt crisis contributing to persistent investor concerns about Spanish banks and the sovereign.⁷

The Moody's announcement came just days before the Bank of Spain said that bad loans rose to 8.37 percent of all banks' outstanding loans, the highest level since August 1994. "In my opinion, Spain is the hottest distressed debt market in Europe right now – the pipeline is considerable. We would expect to see EUR10 to 15 billion of transactions in the next year," says Joel Eduard Grau Blasi, Director in the Portfolio Solutions Group at KPMG in Spain. "Buyers and sellers are on the same page now, with better understanding of the true value of loans and collateral. It is taking longer to close transactions, as parties want deals where there is the potential for profit sharing or deferring portions of the payment, but everyone is open to these structures."

⁷ Moody's Investor Services, 17 May 2012, http://www.moodys.com/research/Moodys-downgrades-Spanish-banks-ratings-carry-negative-outlooks-or-remain-PR_245275?WT.mc_id=BankRatings2012



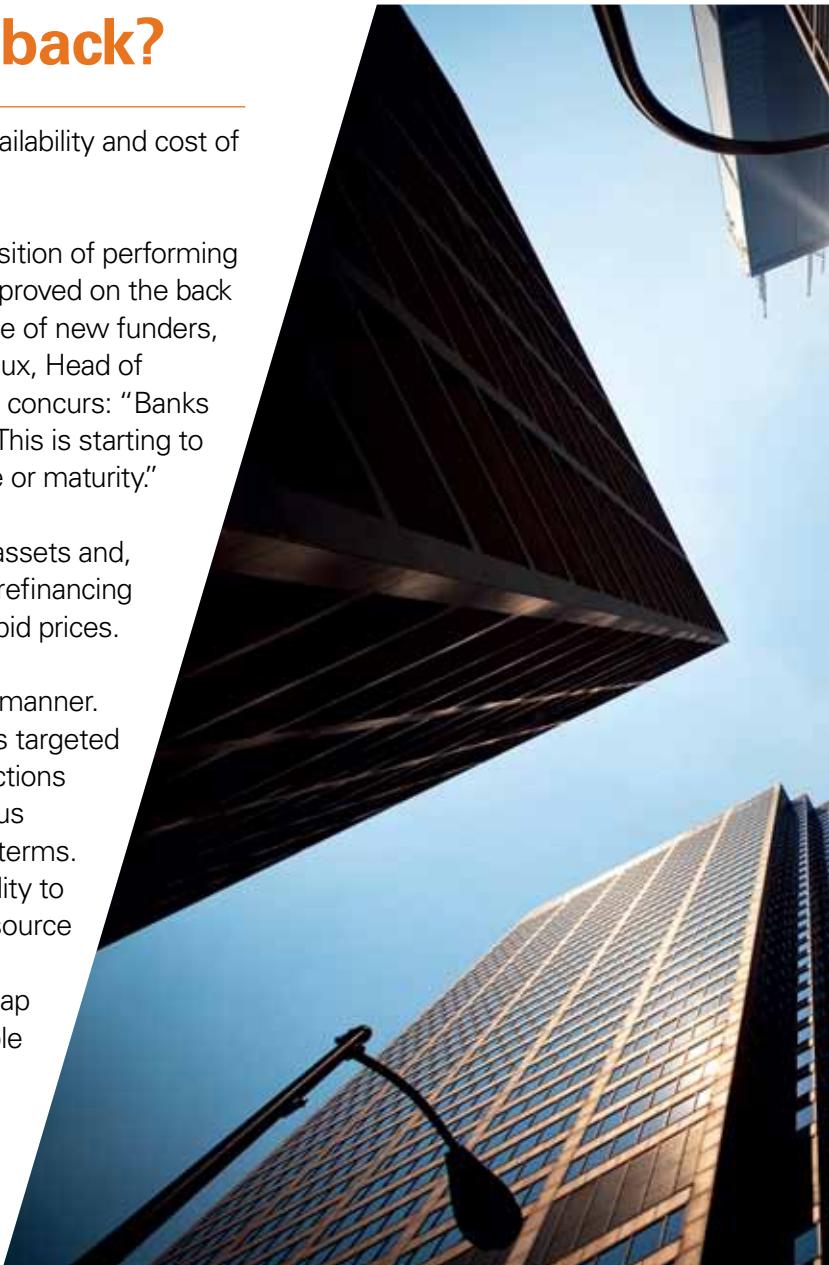
Is leverage on the way back?

With the availability of equity not a major issue, the availability and cost of leverage is key to whether deals are able to close.

"If anything, the cost of secured funding for the acquisition of performing loan portfolios has remained stable or even slightly improved on the back of banks re-entering the fray, as well as the emergence of new funders, including insurance companies," says Philippe Tapernoux, Head of Financial Institutions Debt Advisory in the UK. A buyer concurs: "Banks have slowly overcome their fears of secured funding. This is starting to be reflected in the cost but not yet in the advance rate or maturity."

The funding cost often stays higher than the yield on assets and, with conservative assumptions, buyers must take on refinancing conditions in one, two or three years, meaning lower bid prices.

The situation does not affect every buyer in the same manner. Traditional, longer-term performing mortgage portfolios targeted by private equity houses will be impacted with transactions harder to close given the gap between loan yield versus funding costs, and loan term versus available funding terms. On the other hand, strategic bank buyers have the ability to use retail deposits or covered bonds as an additional source of funding, and established buyers in areas where the returns are higher, such as consumer NPLs, can also tap the corporate high yield bond market. A recent example is debt purchaser Lowell's GBP200 million issue at an annual interest rate of 10.75 percent with a 2019 maturity in March 2012. In the non performing CRE debt sale market, recent financing deals have been at 600 basis points, which seems to effectively have become the benchmark price for such deals.



■■■ The cost of secured funding for the acquisition of performing loan portfolios has remained stable or even improved as banks re-enter the fray and new funders emerge. ■■■

Philippe Tapernoux, Head of Financial Institutions Debt Advisory, KPMG in the UK



Are new entrants aggressive movers?

A substantial number of US funds – notably Centerbridge, Baupost, Kennedy Wilson and DE Shaw & Co – have entered the market in Europe in the last 2 years. The US market is very competitive, with returns being squeezed, prompting many funds to look beyond their home market. There are concerns that the aggressive pricing strategies adopted by some funds, with target equity IRRs in the low-to-mid teens, will squeeze incumbents out of the market.

In particular, we have seen a large focus from US investors on markets such as Spain and Ireland, where they have recently transacted for the first time. Entering a new market doesn't come without its risks and choosing the right servicing partners or anchor portfolio/platform investment is often critical for future success.

"You have a new breed of hungry US investors chasing higher returns than they can achieve at home – and they are pricing the deals accordingly," says Stuart King, Global Co-Leader of the Portfolio Solutions Group.

In addition, we are seeing a number of large Australian performing residential mortgage investors focusing their attention on Europe (most notably the UK and Ireland) looking for anchor portfolio/platforms from which to grow their European presence. This has been evidenced by Pepper Home Loans' reported acquisition of a major US bank's Irish residential mortgage business.

/// You have a new breed of hungry US investors chasing higher returns than they can achieve at home – and they are pricing the deals accordingly. ///

Stuart King, Global Co-Leader, KPMG's Portfolio Solutions Group

Assets coming to market

Spain, the UK, the US and Ireland continue to be viewed by both sellers and buyers as the countries with the highest potential for debt sale transactions globally. Sales will be driven by non-core disposals by big European banks, who have as much as EUR2.5 trillion of deleveraging to undertake.⁸ We estimate that over EUR600 billion of NPLs are sitting with UK, Irish and Spanish banks alone.

Recent high-profile transactions in Germany include Deutsche Wohnen buying the 23,500-apartment German BauBeCon portfolio for EUR1.24 billion from Barclays. Deutsche Wohnen said the enterprise value implies a multiple of 13 and a price of EUR814 per square metre. The deal is the fourth largest residential portfolio transaction in the country this year, following Patrizia's acquisition of the EUR1.4 billion LBBW housing portfolio, TAG's takeover of EUR1.1 billion DKB Immobilien and Cerberus purchasing the EUR1 billion Speymill portfolio. On the debt side, Lone Star's acquisition of the Excalibur loans from Bundesbank remains the largest distressed deal of 2012 in Germany. Outside this transaction, corporate debt deals continue to be done on an asset-by-asset basis at the behest of the bank work-out teams.

The pressure for asset sales in Spain is growing, and we would expect to see EUR10 to 15 billion of transactions over the next 12 months. This will be driven in no small part by the creation of either a centralized Spanish Bad Bank or the requirement of individual banks to create separate vehicles to house their exposures to Commercial Real Estate (CRE) and developer loans. Current estimates put the total exposure of Spanish Banks to CRE at EUR350 billion. The main sellers will be Spanish banks, particularly those that have merged, and foreign banks



⁸ Morgan Stanley: European banks: What are the risks of €1.5-2.5trn deleveraging?, November 2011

Potential for acquisition of portfolio

Buyer Highest Potential



Seller Highest Potential



Source: KPMG International, Global Debt Sales Survey 2012

selling non-core assets, with a continued flow of transactions in the next 4 to 5 years. We have not yet seen evidence of strategic debt purchasers in the Spanish market, with the buyer community comprising mainly hedge funds and private equity funds.

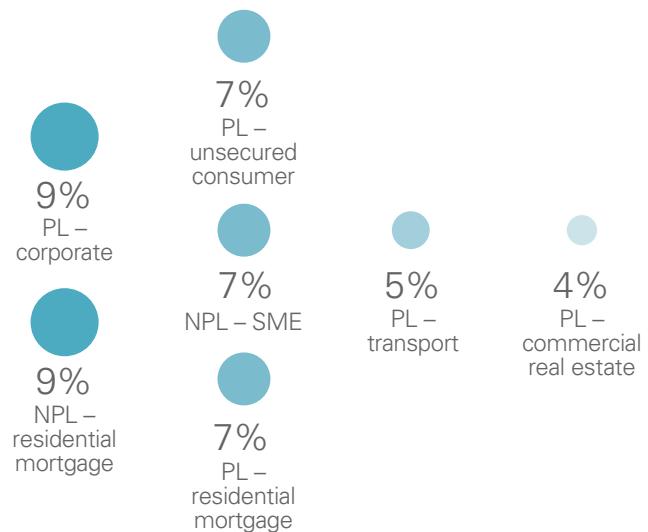
In the UK, despite expectations falling short on occasion, the success of RBS and Lloyds with closing recent CRE loan transactions has offered encouragement for future transactions. As at the time of writing, Lloyds are marketing Project Harrogate, a GBP625 million non-performing property loan (NPL) portfolio, while another major Irish bank is marketing a granular UK commercial property loan portfolio with a reported nominal value of GBP397 million, known as Project Pivot.

/// Price, reputation, efficiency and certainty of execution are key value drivers for portfolio sellers. An open dialogue can lead to solutions for more challenging non-core disposals. //

Justin D. Sulger, AnaCap Financial Partners LLP

Emerging asset classes

Buyer Highest potential



Emerging asset classes

Seller Highest potential



Source: KPMG International, Global Debt Sales Survey 2012

Asset classes

Non-performing unsecured consumer loans are seen as the most likely asset class to come to market in 2012 by 56 percent of buyers, driven by the relatively uniform write-off policy for banks throughout Europe. The market has been seeing an increase in the segment in Spain, the UK and Germany, and activity is expected to increase. Under IAS 39, once an unsecured consumer loan has exceeded 90 days past due, it has to be fully provided for. As a result, any amount that can be achieved from a sale is P&L accretive.

"We estimate that there will be a surge of non-performing consumer loans globally as banks look to clear their warehouses. Banks selling multi-billion Euro consumer NPL portfolios packaged with their servicing platforms and sweetened with forward flow contracts will become increasingly common," says Jonathan Hunt, Associate Director in the Portfolio Solutions Group at KPMG in the UK. In terms of consumer NPL debt sales, 2011 saw the UK consumer debt purchase market return to its pre-crisis levels at over GBP800 million of investment size, which equates to approximately GBP8-10 billion of debt face value. Most consumer debt

■■■ Banks selling multi-billion Euro consumer NPL portfolios packaged with their servicing platforms and sweetened with forward flow contracts will become increasingly common. ■■■

Jonathan Hunt, Associate Director, Portfolio Solutions Group, KPMG in the UK

sellers who were surveyed expect the volume of debt sold in the UK sector to peak in Q4 2012 or Q1 2013 before falling back by between 10-20 percent as banks' warehouses are cleared.

However, while consumer debt has traditionally been the easiest asset to sell, banks are increasingly seeking to sell the different asset classes. Trepp LLC estimates the market for distressed CRE loans in Europe at US\$204.8 billion compared to US\$121 billion at US banks. In the UK and Europe for example, over the past 6 months many vendors have focused on the disposal of CRE backed and leveraged loans, along with residential mortgage loans through both clean or structured trades.

Further, increasingly more challenging and also longer dated assets, such as infrastructure finance, shipping and transport loans are also being considered for sale. These are tough assets for banks to sell because they are very large portfolios, with very low yields and long maturities, and many are priced cheaply. Margins are so thin that it is difficult for buyers to make a return unless they buy at a discount.

To put this in context, if an infrastructure or residential mortgage portfolio has a spread over LIBOR of 150bps and a maturity of 20 years, a buyer with an unlevered return requirement of 6 percent per annum would need to pay no more than 50 to 70 percent of the principle balance outstanding to achieve the target return.

The key issue for the market is therefore tenor, yield and credit quality. In the Private Finance Initiative (PFI) debt space for example, subject to these criteria, several banks have successfully engaged with both pension funds and insurers to sell non-core loan portfolios. We see this trend continuing, as Solvency II, equity yields and greater flexibility by vendors drives innovation from new buyer types and geographies.

At these discounts it is hard for banks to sell because assets are valued at close to par on their books and would therefore result in substantial losses. "Sales of longer-term performing loan portfolios will only be delayed because of LTRO funding and the pricing gap," says Hunt.

*Zach Lewy,
Founder,
Arrow Global*

"2011 and 2012 have seen a return to high levels of debt sale activity in the UK. Volume growth has been driven by structural factors including economic, operational, and accounting considerations. The next few years will likely see a continuation of this enhanced sales activity as the overhang of assets created but not sold in the 2008 to 2010 period come to market combined with creditors selling more debt and higher value debt in response to a UK debt sale marketplace with a better balance of supply and demand."

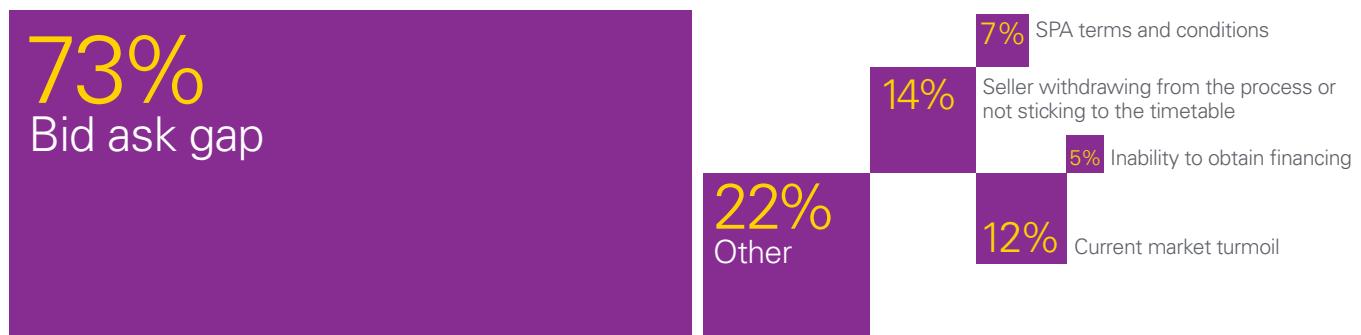
Completing transactions

Overwhelmingly, the reason for transactions failing to complete is the bid-ask spread, cited by 73 percent of buyers and 75 percent of sellers. Buyers said sellers not sticking to the timetable or withdrawing from the process was the principle reason deals failed to complete in 14 percent of cases, while current market turmoil affected 12 percent of situations.

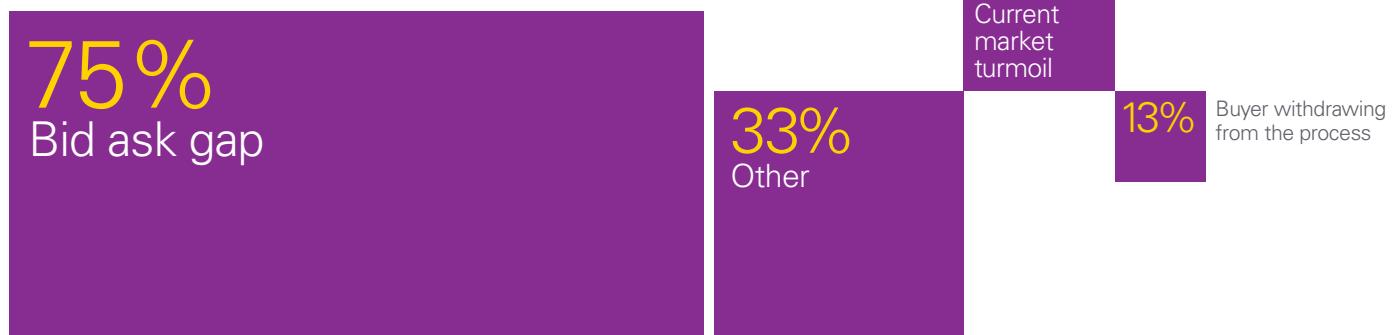
We believe that the price expectation gap is starting to close and that buyers and sellers are now at least on the same page. In some cases, transactions are taking longer to close and need to be structured in a way

Potential for acquisition of portfolio

Buyer



Seller



Source: KPMG International, Global Debt Sales Survey 2012

5%

Of the transactions in this survey were completed with vendor finance

that allows buyers and sellers to share the upside. We also expect to see an increase in vendor finance, which in our survey accounted for just 5 percent of deals.

There are regulatory constraints in some major markets that are blocking vendor-financed deals. In Spain, for example, if a seller retains a 25 percent equity interest or provides vendor finance for 25 percent of the value then Banco de España will say that the risk has not been sufficiently reduced or eliminated and will not allow the assets to be deconsolidated from the vendor's accounts.

German buyer

"Those banks which have been reluctant to write-off bad debt and have kept it on their balance sheet for longer will come under pressure to clear out their books."

German consumer debt seller

"Prices for consumer debt will not reach 2006 levels but there is still plenty of room for upside. Prices should increase until demand declines."

Spanish seller

"In terms of secured loans the remaining price gap will start to narrow, due to the new provisions law which was passed this year, and due to investors' expectations on collateral price evolutions being more in line with the sellers."

UK consumer debt seller

"We have seen a shift from smaller 'business as usual' sales to balance sheet driven decisions, and with this comes fewer, larger, structured sales."

What types of sales processes were undertaken?



Source: KPMG International, Global Debt Sales Survey 2012

Sales processes

Our survey found that bilateral sales processes accounted for 48 percent of transactions, with 41 percent through auctions and 11 percent through combined processes. Not surprisingly, buyers reported an increased bias towards bilateral processes, with 55 percent of respondents saying they had completed a bilateral transaction. In addition, our survey found a high number of 'single name' credit sales occurring.

What form was the acquisition(s)/disposal(s)?



Source: KPMG International, Global Debt Sales Survey 2012



BRIEFING

STRUCTURING TRANSACTIONS

In the consumer debt sales market, with larger transaction sizes, innovative deal structuring mechanisms are becoming more common to help maximize transaction value.

As portfolio sizes grow and investment sizes increase, the way deals are structured becomes increasingly important. This can have a significant positive impact on pricing even where these structures are relatively short-term.

Structured deals can take many forms from forward flows, joint venture/upside arrangements with assets transferred into special purpose vehicles, to price deferrals and post-deal price adjustment agreements. Each of these structures can be mutually beneficial for seller and purchaser, which in turn can drive returns.

Having said this, despite the keenness of some of the more advanced purchasers to explore these deal structures with sellers, many of the debt sales teams within the banks still have a preference to 'keep deals simple' and focus on speed and ease of execution – perhaps leaving value on the table for both parties? The useful lessons from CRE loans sales, such as RBS's CRE loan portfolio sale to Blackstone (Project Isobel), could be transposed to other markets and asset classes.

Return requirements

Return requirements on deals increased over the past year, with 47 percent of buyer respondents saying they have increased their target internal rates of return (IRRs) and 47 percent saying they had not changed. Investors interviewed said that increased turmoil in financial markets led to them seeing a higher return. One noted that developed markets were generating emerging-market-level returns, which meant that they needed to add an even higher premium for investment, in emerging markets.

"The funds we have were raised with a certain IRR hurdle and we are not changing it. Our underwriting assumptions may get harder to reflect the current turmoil," said one buyer.

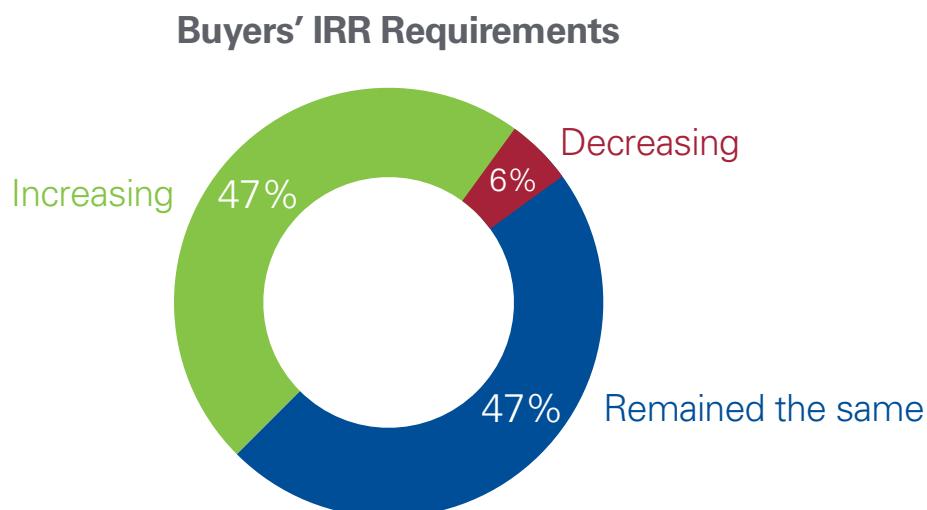
IRRs vary across markets in line with risk. Germany is seen as a lower risk market and best positioned to deal with any fallout from the Eurozone, as opposed to Spain which is commanding a higher IRR from debt buyers in line with higher risk.

We may be at an inflection point in terms of returns. The lack of supply of assets in some markets is increasing competition for the transactions that are out there, so buyers will have to take a hit on the return if they are to win the transaction. While in other markets such as Spain, Portugal and parts of Central and Eastern Europe, buyers are requiring higher and higher returns to take on the uncertainty. This is best evidenced in the UK where the buyer market for residential NPLs is far greater than the available supply. The outcome has therefore been favorable for vendors, as buyer competition and low teen IRRs have driven pricing far higher.

■■■ Maturity defaults and foreign banks retrenching will create a German NPL opportunity larger than in the last cycle. ■■■

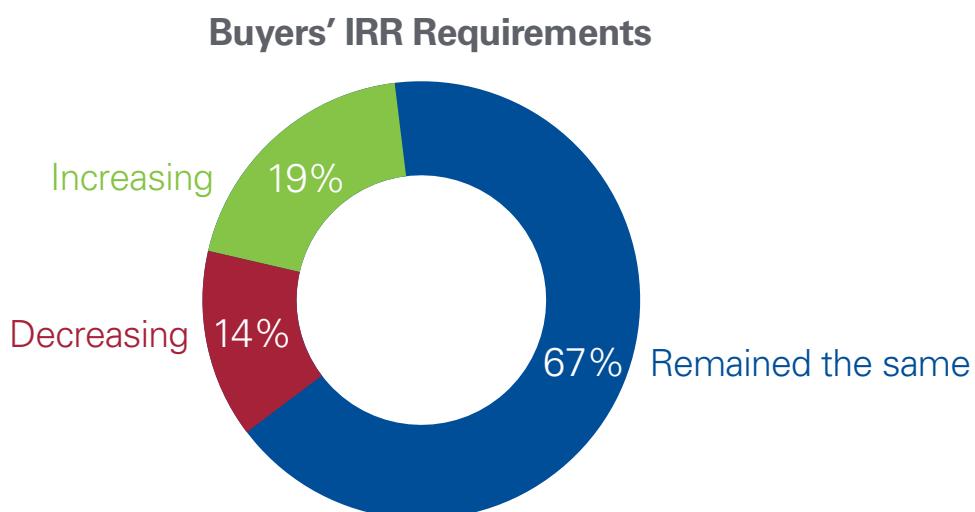
Dr. Ruprecht Hellauer, Founder of Albulus Advisors Germany GmbH

Did your IRR requirements a) increase b) decrease or c) remain the same in 2011 as compared to 2010?



Source: KPMG International, 2012

Do you envisage your IRR requirements a) increasing b) decreasing c) remaining constant for 2012 as compared to 2011?



Source: KPMG International, 2012

■■■ We are seeing buyers in the UK drifting towards a low-teens IRR for 'stressed' portfolios to get deals done and to feed their acquisition and servicing machines. ■■■

Andrew Jenke, Director, Portfolio Solutions Group, KPMG in the UK

The majority (67 percent of buyer respondents) said they did not expect to change their return requirements in 2012, though there was a slight bias towards seeking a higher return, with 19 percent saying they were seeking a higher return against 14 percent expecting a fall. "Significant continued volatility in financial markets through at least the first half of 2012 combined with continually increasing stock of assets offered for sale should not create an environment where we would adjust yields down," said one buyer.

The main issue is whether the buyer is targeting performing or non-performing assets, because the IRR is correlated to the risk. For example, on Project Royal, a portfolio of NPLs sold by Lloyds Banking Group, we understand that the target equity return of the buyer was reported at around 18 percent, because of the perceived poor quality of the underlying assets. On Project Isobel, Royal Bank of Scotland's GBP1.36 billion portfolio sale, the equity return was reported to be far lower, reflecting the higher overall quality of the borrowers.

"We are seeing buyers in the UK drifting towards a low-teens IRR for 'stressed' portfolios to get deals done and to feed their acquisition and servicing machines," says Andrew Jenke, Director in the Portfolio Solutions Group, KPMG in the UK.

UK Buyer

"Significant, continued volatility in financial markets through at least the first half of 2012 combined with continually increasing stock of assets offered for sale should not create an environment where we would adjust yields down."

US Buyer

"The funds we have were raised with a certain IRR hurdle and we are not changing it. Our underwriting assumptions may get harder to reflect the current turmoil."

A global perspective

KPMG's Portfolio Solutions Group is one of the world's leading practices with a global footprint and specialists focused exclusively on key markets in Europe, Asia, Latin America and the US. Here members of the team analyze the key developments in those markets.

EUROPE Andrew Jenke

Director, Portfolio Solutions Group, KPMG in the UK



Europe has certainly emerged as the key focus for those parties looking to take advantage of the recent credit and sovereign crises, and the bank deleveraging that has followed.

Importantly, the deleveraging focus of European banks has very much been spread across different product types (such as CRE, PFI and residential mortgages), different geographies (from Australia to Ecuador) and varying degrees of credit quality (from deeply distressed to investment grade).

Deal activity, both for performing and non-performing loans, has been most prevalent in Spain, the UK and Ireland, with over EUR600 billion of NPLs on their balance sheets. Other markets continue to generate high profile transactions and buyer interest, such as Portugal, Germany and Italy.

Activity in the Spanish market has been steadily building for over 2 years now, with the wave of primarily foreign private equity (e.g., Cerberus, Lone Star) and investment bank (e.g., Morgan Stanley, Deutsche Bank) buyers now having to compete with an increasingly sophisticated set of well funded servicing platforms. While the market rallied on the back of unsecured NPL transactions, real estate backed loan sales, both for residential and commercial, have become the focus for new foreign buyers stimulated by new provisioning rules, as shown by over EUR500 million of residential mortgage NPLs being sold within the first 6 months of 2012. Going forward, we expect the Spanish market to continue to grow as banks really begin to tackle their commercial real estate loan challenges and established buyers seek to feed local, recently built, machines.

Ireland is a relative newcomer to the debt sale market and for this reason banks and investors don't have five years worth of bid/ask

closing experience to draw upon. Given the scale of the macroeconomic real estate declines across the country, this has made transactions extremely challenging without a very motivated and informed vendor. While a number of transactions have been seen in the market, those that have closed have largely been as a result of foreign banks seeking to exit the Irish market, such as Lloyds's loan portfolio sales to two US investors, and a major US bank's mortgage business sale to Pepper Home Loans, both in late 2011/2012. It is also worth remembering that the majority of disposals within Ireland thus far, have focused on both performing and non-performing loans. Given the buyer community for these assets to date, little sign of strategic or long-term financial interest in Irish assets has yet to emerge.

The UK is a bifurcated market – we see a very competitive and increasingly heated consumer NPL market where new overseas entrants are competing with established private equity owned players (such as Lowell, Arrow Global, Cabot Financial, etc.), with the result that pricing and dealflow are increasing. The key question will be whether this buyer audience and the existing debt sale practices of UK banks will be sufficient to handle the quantum of consumer NPLs residing on bank balance sheets. Beyond this we have the issue of non-core, particularly CRE, Leveraged Buyout (LBO) and residential mortgage, assets residing on both local and foreign bank balance sheets. While a challenge for banks headquartered from London to Dublin to Johannesburg to Melbourne, the desire and the commercial rationale to dispose of these assets in the UK has thus far been limited, with one important exception. Lloyds has actively sought to unwind non-core legacy loan books in the UK spanning unsecured NPLs, CRE and leveraged loans to primarily private equity buyers. As other banks — notably IBRC (formerly Anglo Irish Bank) — seek to follow, the question remains whether this heralds the start of the great UK bank asset sell off that many have been predicting for 3 years.

Finally, it is worth noting that despite its historical activity and central role in the 2008 credit crisis, German banks are currently under little pressure to sell assets, despite ratings downgrades, because of the overall strength of the economy and sovereign. There have been some substantial transactions in the housing market, but few cases of German banks selling German assets. Further, with a few exceptions, we do not expect a great deal of activity from foreign-owned banks disposing of German assets to increase going forward.



US\$40bn

The sum Ireland's 'bad bank' Nama paid in 2009 for US\$92 billion of real-estate loans

ASIA PACIFIC Frank Janik

Partner, Portfolio Solutions Group, KPMG in Thailand



Broadly speaking, the market for debt sales in Asia-Pacific can be divided into two camps: the developed and the developing economies. Asia's financial crisis precedes that of the west by a decade, so in terms of sales of loan portfolios the market has been active for some time now and is to an extent mature. Central banks became cognizant of the fact that non-performing loans on the balance sheets of their banks were increasing and brought in regulations to force banks to clean up their act. Regulations were passed in Taiwan, the Philippines, Thailand, Malaysia, and India to make asset sales more attractive and now there are a number of banks in the region that see debt sales as a way of managing their problem loans. Korea has been an active market in the last year and we have seen a number of unsecured credit card portfolios coming out. However, it is a very domestic market and you need a local presence or partner.

Asia's banks are relatively healthy and we are now seeing a reversal of the historic trend, with a lot of Asian money flowing into Europe and the US. Asian money is targeting property and infrastructure assets to gain a foothold in new markets. Sovereign wealth funds have put aside billions of dollars to invest in Europe, where they are focused on performing assets, particularly in strategically important sectors such as energy and food production.

Australia and Japan sit as standalone markets in the region and the pattern of asset sales is more comparable with Europe or the US and it is these countries where European banks have the majority of their exposure to the region. Foreign banks are trying to exit portfolios that are largely performing, non-core assets. We also expect to see increased activity from Australia's second tier banks, who expanded into property-based, project-finance-based lending which they did not really have the expertise to manage and so are sitting on some problematic portfolios.



■■■ Asian money is flowing into Europe and the US, targeting property and infrastructure assets to gain a foothold in new markets. ■■■

LATIN AMERICA Nicolas Malagamba

Associate Director, Portfolio Solutions Group, KPMG in Spain



Brazil is ripe for overseas investment. There are over US\$100 billion of non-performing loans, despite the fact that the economy has been performing well. Consumption has been increasing significantly, growing at more than 30 percent per annum and some of the credit is of questionable quality. Local banks are starting to consider sales and US investors with captive platforms are the main potential buyers for those assets. US investors are starting to look back to Brazil because returns in the US are under pressure and they see Brazil as a country where they can achieve improved performance.

The market also suffers from a lack of information regarding the loans and borrowers, particularly in relation to corporate loans. This negatively affects the pricing assumptions applied by investors, therefore generating riskier scenarios, higher return expectations and creating pricing gaps. We have already seen some activity by local and regional investors who are exploring structuring alternatives as a means of bridging that expectation gap.

There is also an opportunity to invest in servicing platforms, which would likely give an aggressive investor a higher return. Brazil is a massive country and very fragmented in the way it goes about collecting and servicing debts. We would expect the country to follow the pattern of other markets, where collection companies start raising money to buy the debt they have been servicing and then there is consolidation into a smaller number of more serious players with representation across the major cities. Brazil is on the first stage of that journey, so it is a very attractive market for an investor with tolerance for risk.

Elsewhere in the region we are seeing signs of greater activity, though markets are not always favorable for overseas investors. In Chile, large banks are considering exiting some non-performing loans and in Mexico there has been sporadic trades of residential mortgages and unsecured portfolios. We expect to see activity in that market in the near future.



■■■ Brazil is on the first stage of a consolidation journey, so it is a very attractive market for an investor with tolerance for risk. ■■■

UNITED STATES Hernan Magarinos

Director, Portfolio Solutions Group, KPMG in the US



When IBRC (formerly Anglo Irish Bank) sold a very large US\$9.5 billion loan portfolio in a single transaction, we expected that sale to be an inflection point and a precursor to increased activity.

Though the loan sales activity has picked up slightly, large portfolio transactions have not materialized and we have only seen a handful of transactions over US\$200 million. However, every piece of analysis we do points to more activity in the coming months. According to Trepp, there is as much as US\$1.7 trillion of real estate loans coming due in the next 5 years and as many as 50 percent of those are under water.

The larger banks are better capitalized due to better access to capital markets and therefore in a better position to sell loans. It is estimated that currently there could be up to 800 banks on FDIC's 'problem banks list'. These banks typically are trading on very low amounts of capital with few prospects of raising new equity. Taking into account potential write-offs, they are already at the point where they should be on FDIC lists and/or should have been liquidated. These banks are trying to 'extend and pretend' but with new maturities coming due, something will have to give. We believe there will be extra force for these banks to sell more assets, using creative structures that will allow them to maintain a minimum capital level.

Another factor that has slowed sales of non-performing loans was the deregulation in Troubled Debt Restructurings (TDRs), which has effectively allowed banks to re-classify loans as TDRs so long as they are able to restructure under 'market conditions'. This could be making some banks' balance sheets look healthier than they really are. You would have to ask whether some of these TDRs are not just future NPLs.

In terms of market activity, there is interest for both performing and non-performing loans, which is a change from recent years when there was limited buyers' appetite for performing loans. Now we are seeing interest from commercial banks to buy performing assets or finance other buyers' acquisitions, whereas for non-performing loans the main players are still the specialist funds.

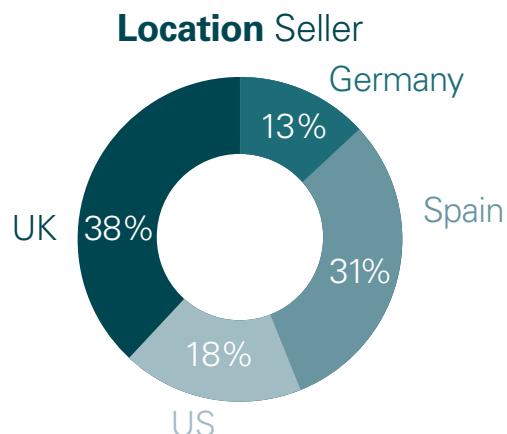
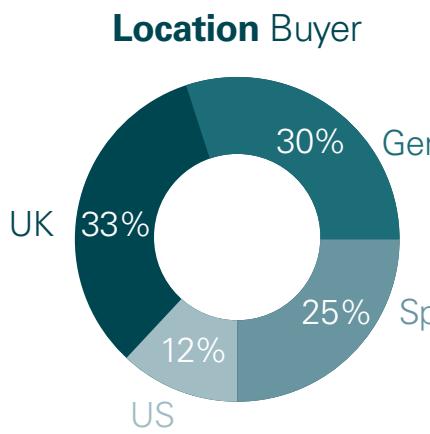
The main asset class in the market is CRE. There is appetite from buyers for C&I (Commercial & Industrial) and PFI (Project Finance) loans, but since these assets are pretty stable most banks are reluctant to sell them.

US\$1.7trn
*Real estate loans coming due
 in the next five years in the US*

About the research

KPMG conducted an online survey of buyers and sellers of loan portfolios in Q1/Q2 2012. The survey, which was designed to identify some of the trends in the global debt sales market, targeted buyers of loan portfolios, including strategic buyers, private equity, investment banks and opportunity funds, and sellers, including commercial banks and other financial institutions. Representatives of 57 organizations completed the survey.

Buyers and sellers were located in the UK, Germany, Spain and the US.



Source: KPMG International, Global Debt Sales Survey 2012

More than two-thirds (68 percent) of buyers had made an investment in 2011, while a similar proportion of sellers (65 percent) had completed a transaction. Completed transactions covered a wide range of deal types and sizes, including commercial real estate, corporate, residential mortgages, unsecured consumer and infrastructure finance, with transaction portfolio book values ranging from EUR1 million to around EUR500 million.

GLOBAL DEBT SALES SURVEY 2012

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