



# DARP—Creating Distressed Assets Markets

LESSONS LEARNED SINCE THE GLOBAL FINANCIAL CRISIS AND  
OPPORTUNITIES FOR INVESTORS IN EMERGING MARKETS TODAY

Distressed Asset Recovery Program



*Creating Markets, Creating Opportunities*

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# CONTENTS

6		FOREWORD
8		INTRODUCTION
10		EXECUTIVE SUMMARY
13		CHAPTER 1 DARP: Creating Markets to Promote Development and Financial Stability
28		CHAPTER 2 The Legal Framework Behind a Distressed Assets Market: Insolvency, Enforcement, and Workouts
34		CHAPTER 3 Public Asset Management Companies
46		CHAPTER 4 Attractive Markets for Investing in Distressed Assets
69		CONCLUSION
70		REFERENCES
72		FURTHER READING



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## Figures, Tables, and Boxes

<b>FIGURE 1.1</b> High Levels of NPLs Led to Reduced Lending . . . . .	13
<b>FIGURE 1.2</b> DARP's Global Network of Partners . . . . .	15
<b>FIGURE 1.3</b> DARP's Investments: Building Resolution Capacity and Mobilizing and Deploying Capital. . . . .	17
<b>FIGURE 1.4</b> DARP in Colombia: Timeline . . . . .	19
<b>FIGURE 1.5</b> Bridging the Pricing Gap. . . . .	21
<b>FIGURE 1.6</b> How DARP Can Create and Deepen Local Capital Markets . . . . .	22
<b>FIGURE 1.7</b> DARP Key Milestones, 2007–19. . . . .	25
<b>FIGURE 1.8</b> Selected DARP Results . . . . .	25
<b>FIGURE 2.1</b> Recovery Rate Based on Time to Resolve Insolvency and Outcome . . . . .	32
<b>FIGURE 3.1</b> Two Types of Public AMCs. . . . .	35
<b>FIGURE 3.2</b> Comprehensive NPL Management Strategy . . . . .	39
<b>FIGURE 3.3</b> State Aid in the Transfer of Impaired Assets. . . . .	40
<b>FIGURE 3.4</b> Real Economic Value from Previous Cases. . . . .	40
<b>FIGURE 4.1</b> Brazil—Total Loans . . . . .	49
<b>FIGURE 4.2</b> Brazil—E-H Rated Loans . . . . .	49
<b>FIGURE 4.3</b> China—Total Loans . . . . .	53
<b>FIGURE 4.4</b> China—NPLs . . . . .	53
<b>FIGURE 4.5</b> Greece—Total Loans . . . . .	56
<b>FIGURE 4.6</b> Greece—NPLs . . . . .	56
<b>FIGURE 4.7</b> India—Total Loans . . . . .	58
<b>FIGURE 4.8</b> India—NPLs . . . . .	58
<b>FIGURE 4.9</b> Turkey—Total Loans . . . . .	62
<b>FIGURE 4.10</b> Turkey—NPLs . . . . .	62
<b>FIGURE 4.11</b> Ukraine—Total Loans . . . . .	66
<b>FIGURE 4.12</b> Ukraine—NPLs . . . . .	66
<b>TABLE 3.1</b> Examples of Public AMCs. . . . .	44
<b>TABLE 4.1</b> Legal and Regulatory Framework . . . . .	47
<b>TABLE 4.2</b> Greece: Summary of NPL Sales . . . . .	57
<b>BOX 1.1</b> Benefits of a Distressed Assets Market . . . . .	16
<b>BOX 1.2</b> DARP, Innovation Across Distressed Assets Markets—Part 1 . . . . .	19
<b>BOX 1.3</b> DARP, Innovation Across Distressed Assets Markets—Part 2 . . . . .	23
<b>BOX 2.1</b> The London Approach . . . . .	30
<b>BOX 2.2</b> Regulatory and Tax Impediments . . . . .	33
<b>BOX 3.1</b> AMCs of Vietnam and China . . . . .	43
<b>BOX 4.1</b> DARP Involvement in Brazil . . . . .	51
<b>BOX 4.2</b> DARP Involvement in China . . . . .	55
<b>BOX 4.3</b> DARP Involvement in Greece . . . . .	57
<b>BOX 4.4</b> Insolvency, Bankruptcy, and NPL Resolution Progress in India . . . . .	60
<b>BOX 4.5</b> DARP Involvement in India . . . . .	61
<b>BOX 4.6</b> DARP Involvement in Turkey . . . . .	64
<b>BOX 4.7</b> DARP Involvement in Ukraine . . . . .	67

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## Abbreviations and Acronyms

**AMC** Asset Management Company  
**AMCON** Asset Management Corporation of Nigeria  
**ARC** Asset Reconstruction Company  
**BAMC/DUTB** Bank Asset Management Company  
**BCR** Banca Comercială Română  
**BRSA** Banking Regulation and Supervision Agency  
**CAGR** Compound Annual Growth Rate  
**CBIRC** China Banking and Insurance Regulatory Commission  
**CCBC** China Construction Bank Corporation  
**CISA** Central de Inversiones S.A.  
**DARP** Distressed Asset Recovery Program  
**DCF** Discounted Cash Flow  
**DIP** Debtor-in-Possession  
**E&S** Environmental and Social  
**EBL** Enterprise Bankruptcy Law  
**ECA** Eastern Europe and Central Asia  
**EMS** Emerging Markets  
**EU** European Union  
**FCI GP** Finance, Competitiveness & Innovation Global Practice  
**FOGAFIN** Fondo de Garantías de Instituciones Financieras  
**FY** Fiscal Year  
**GOI** Government of India  
**GDP** Gross Domestic Product  
**IBBI** Insolvency and Bankruptcy Board of India  
**IBC** Insolvency and Bankruptcy Code  
**IBRA** Indonesian Bank Restructuring Agency  
**ICA** Inter Creditor Agreement  
**ICBC** Industrial and Commercial Bank in China  
**IFC** International Finance Corporation  
**IMF** International Monetary Fund  
**IPO** Initial Public Offering  
**IRP** Insolvency Resolution Professional  
**KAMCO** Korea Asset Management Corporation

**KPI** Key Performance Indicators  
**LMC** Loan Management Company  
**MENA** Middle East & North Africa  
**MSME** Micro, Small, and Medium-Sized Enterprise  
**NAMA** National Asset Management Agency  
**NBFC** Non-Bank Financial Company  
**NBFI** Non-Bank Financial Institution  
**NCLT** National Company Law Tribunal  
**NPL** Non-Performing Loan  
**OCW** Out-of-Court Workout  
**RBI** Reserve Bank of India  
**REO** Real Estate Owned Assets  
**REV** Real Economic Value  
**RTC** Resolution Trust Corporation  
**SAREB** Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria  
**SDIF** Savings Deposit Insurance Fund  
**SME** Small and Medium-Sized Enterprise  
**SML** Special Mention Loan  
**SOE** State-Owned Enterprise  
**SSA** Sub-Saharan Africa  
**UNCITRAL** United Nations Commission on International Trade Law

*Note: All dollar amounts are U.S. dollars unless otherwise indicated*

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# FOREWORD

The flow of credit is essential to economic growth, development, and vibrant financial markets. And while all economies experience periods of financial instability, many emerging economies lack the tools to adjust, leaving them more vulnerable to boom and bust cycles, with negative consequences for households and businesses. Non-performing loans are a natural consequence of expanded credit, but without the means to effectively resolve them, economies will falter.

This is why we at the International Finance Corporation place such a high value on our Distressed Asset Recovery Program, or DARP. If we are to fulfill our mission of developing new and stronger financial markets for private sector solutions in emerging economies, we must deploy effective tools and solutions to ensure financial stability and maintain the flow of credit across the markets in which we work.

DARP fits the bill. IFC's mandate for creating markets, as formulated in our IFC 3.0 strategy, means both helping to initiate them as well as intervening when necessary to maintain their stability and capacity to recover.<sup>1</sup> In collaboration with the World Bank, DARP offers the ability to systematically intervene in financial markets to address the problem of rising levels of distressed assets. This aligns it perfectly with IFC's cascade approach of implementing reforms to address market failures and other constraints to private sector investment.

As such, DARP leverages the upstream work done by the World Bank's Finance, Competitiveness & Innovation Global Practice to support the development of robust regulatory regimes for distressed assets resolution, and combines it with pioneering, market-based interventions that mobilize capital and expertise from leading private sector distressed assets investors.

For example, in India, where a large stock of non-performing loans—currently the equivalent of approximately \$134 billion—created a negative feedback loop that slowed credit expansion and reduced financial inclusion and economic growth, DARP worked closely with the World Bank to develop a dynamic market for distressed assets resolution. This included technical assistance to strengthen the

credit environment by improving the insolvency and bankruptcy code, as well as a range of distressed assets solutions, including the first dedicated platform to target mid-to-large distressed companies.

Similarly, in Colombia, in certain countries across the Caribbean, as well as in other countries in Eastern Europe, DARP has significantly contributed to the creation of new, vibrant markets for non-performing loans. In other countries such as Brazil, the Philippines, and Mexico, where NPL markets were more developed but fell out of favor with investors after the crisis of 2008, DARP helped re-activate dormant markets for distressed assets.

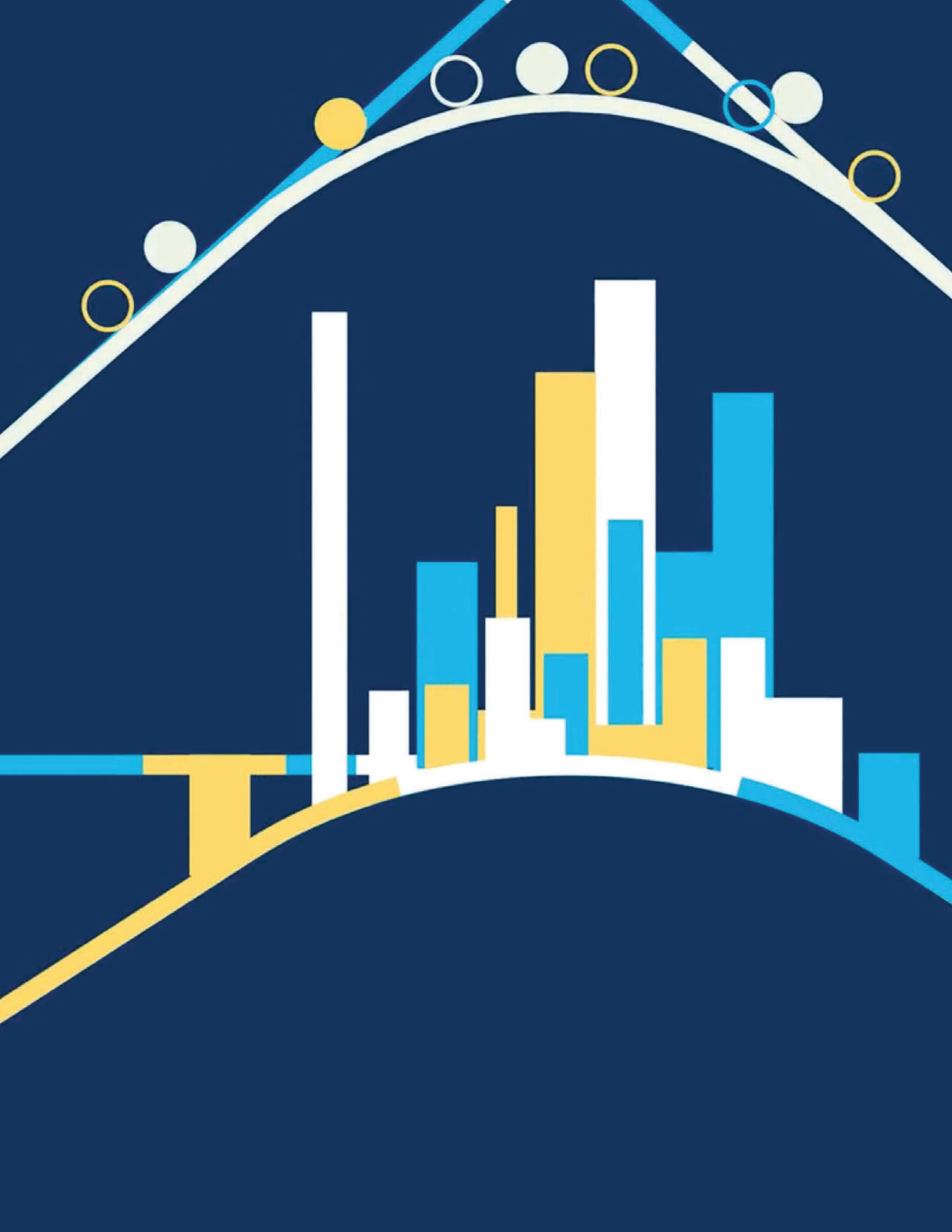
These approaches have allowed DARP to play a critical role in providing stability to financial systems across emerging economies. Over the last decade, DARP and its partners have committed more than \$7.3 billion to the acquisition and resolution of distressed assets. This has enabled financial institutions to remove over \$30 billion of problem loans from their balance sheets, facilitating new lending into these economies; it is helping more than 18 million small and medium enterprises and households become debt free so that they regain access to finance; and it has introduced best resolution practices. This report examines insights and lessons learned since DARP was launched in 2008.

I invite you to engage with us on this critical topic.



**PAULO DE BOLLE**  
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# INTRODUCTION

Every financial system has faced or will face a crisis at some point. But even in the absence of a crisis, the extraordinary growth in credit over the last two decades has resulted in an increase of non-performing loans (NPLs), which are an unavoidable by-product of lending. This can put economies at risk. When not addressed, distressed assets can grow to reach critical thresholds that can slow down, or even prevent, economic recovery and increase unemployment, creating a vicious circle that is difficult to break. Well-developed distressed assets markets can interrupt this loop, allowing for a return to economic growth and financial stability. However, this requires that all stakeholders—each inevitably with different motivations—are prepared to reach compromises. Similarly, the magnitude of the NPL problem is so severe in many economies that collaboration between the private and public sectors is also crucial. In response to these challenges, the International Finance Corporation (IFC) is taking the lead in supporting the development of strong distressed assets markets across emerging economies through its Distressed Asset Recovery Program (DARP) and capitalizing on the attractive investment opportunities deriving from these challenges.

The problem is clear and severe: high NPL volumes are a major problem facing emerging economies. Considering the NPLs on the balance sheets of banks alone, there is an estimated \$1 trillion of distressed assets representing capital that could be put to more productive use. However, when restructured and written-off loans are taken into account, as well as other assets categorized as special mention or similar loans, the total stock of banks' distressed assets is much larger. First, large stocks of NPLs limit credit expansion and financial inclusion, as they adversely impact banks' capital and profitability, and therefore their ability to supply credit to fuel economic growth. Second, defaulted borrowers gradually lose access to financing and are at risk of losing their assets. Third, the absence of adequate credit availability defers planned investments and keeps many high-potential small and medium enterprises (SMEs) and corporates from recovering from financial distress, causing significant production and job losses. Fourth, the large overhang of NPLs may require capital injections from the banks' shareholders to take capital adequacy to acceptable levels, while it can also impose a major fiscal burden on governments that may need to recapitalize systemic banks.

If no action is taken, however, and the volume of NPLs continues to rise, there is a risk that banking systems

across emerging markets (EMs) may face challenges at a systemic level. To alleviate this risk, an efficient and effective distressed assets resolution system is critical to: (a) allow banks to dispose of their non-productive assets and free up capital to resume lending, (b) help individuals, SMEs and corporates regain access to the financial system while keeping their most valuable assets such as their homes or their key productive assets, and (c) restructure and refinance potentially viable companies to preserve existing jobs and create new ones.

Many stakeholders, from both the private and public sectors, need to be involved to create sound distressed assets markets. Given the magnitude of the NPL problem, as well as the need for significant capital and expertise, private sector participation is crucial. The ecosystem of a well-developed distressed assets market includes the following elements:

- Regulators are key, since a legal framework that enables the efficient transfer of these NPLs and allows for their proper resolution is a precondition for distressed assets markets to develop. In the absence of a clear, sound, and efficient legal, regulatory, and judicial process, market participants lack the certainty required to pursue the sale and acquisition of NPLs.

- Sellers needing to offload their NPL portfolios must recognize the benefits of disposing of them. These include strengthening of their balance sheets, providing liquidity, reducing the cost of managing these non-core assets, freeing up management to focus on their core business, and avoiding potential contamination of their performing loan portfolios.
- Buyers must acknowledge that, in addition to maximizing their return, the use of best practices in their resolution process is key to the sustainable development of a distressed assets market—not only because dealing with debtors in an appropriate and ethical way maximizes the chances of an actual recovery, but also because sellers are very concerned with their reputation. An investment in best practices in the short term helps promote a healthy market where buyers can achieve long-term positive returns.
- Servicers should look at debtors as clients and build long-term relationships based on trust to optimize recoveries. They also need to understand the importance of aligning their interests with investors and not just focus on maximizing their revenues in the short term. Of equal importance is for servicers to be up to date on new technologies that are fundamentally changing the way collections are performed.
- Advisors, both on the sell side and on the buy side, play a key role in matchmaking. To be effective, they need to look after the interests of both ends of the trade, rather than just trying to maximize short-term returns for their clients.

This report is structured in four chapters. Chapter 1 provides an overview of DARP, how DARP addresses market inefficiencies today, and what DARP will focus on going forward. Chapter 2 examines the importance of having a robust legal framework that enables the development of distressed assets markets, while Chapter 3 explores how the establishment of public asset management companies (AMCs) can complement the crucial private sector involvement. Finally, Chapter 4 looks more closely at several markets where most preconditions for large-scale distressed assets resolution are being put in place. These warrant a closer look by investors seeking opportunities in distressed assets markets.

As a leader in this ecosystem, IFC, through DARP, has had a significant impact over the last decade, building the infrastructure needed for the resolution of distressed assets globally and serving as a catalyst for the creation of vibrant secondary markets around the world. However, this would not have been possible without the active participation and valuable contribution of the relevant distressed assets stakeholders. Thanks to the partnerships established over the years, DARP has committed over \$7.3 billion, allowing financial institutions to offload NPLs of more than \$30 billion in face value, thereby improving their liquidity levels and freeing up capital for new loans. At the same time, DARP platforms are helping normalize the obligations of more than 18 million households and businesses. This unique DARP global network enables IFC to continue playing its active role in developing local distressed assets markets across emerging economies as well as mobilizing private sector capital and expertise. ■



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## EXECUTIVE SUMMARY

The extraordinary growth in credit over the last two decades has resulted in an elevated level of distressed assets. This can reduce lending and slow down, or even prevent, economic recovery, creating a vicious circle that can be difficult to break. Robust distressed assets markets can interrupt this loop, thereby allowing for a return to economic growth and financial stability. They allow banks to dispose of their non-productive assets and resume lending, enable borrowers to regain access to the financial system, and create an environment for the successful restructuring of viable companies. This, however, requires compromises among stakeholders and collaboration between the public and private sectors.

### **IFC Plays an Important Role in Creating Distressed Assets Markets**

For more than a decade, IFC has supported the development of strong distressed assets markets in emerging economies through DARP—the Distressed Asset Recovery Program. DARP’s strategy is based on two pillars: first, building the essential servicing infrastructure required across markets; and second, deploying capital, including capital mobilized from third-party investors, to acquire and resolve distressed assets. This work also brings to light any shortcomings in the applicable legal and regulatory frameworks, which can then be addressed to strengthen the overall debt resolution ecosystem. In this sense, DARP has proven to be an efficient tool for creating new distressed assets markets as well as strengthening the development of existing markets.

DARP has the tools and resources to address and mitigate impediments to healthy distressed assets markets, enabling development over time. Since 2007, commitments under DARP have grown to over \$7.3 billion globally, of which \$2.7 billion comes from IFC’s own account and \$4.6 billion from third-party investors. This has allowed banks to offload a face value of more than \$30 billion in NPLs and is helping normalize the obligations of about 18 million borrowers. DARP has also fostered best resolution practices for NPLs, including best environmental and social (E&S) policies and procedures. IFC has therefore played a critical role in the development of NPL markets in emerging economies across the world, including India, Colombia, Brazil, and several countries in Eastern Europe.

### **The Legal Framework Behind Distressed Assets Markets**

A well-developed legal and institutional regime is key to maintaining an acceptable risk level, allowing distressed assets markets to develop. Enabling measures for dealing with insolvency, enforcement, and the ability to achieve out-of-court workouts (OCW) are essential. Laws and regulations that favor smooth transactions and loan transfers allow investors to enforce their claims and collateral efficiently and provide mechanisms for both out-of-court restructuring and efficient in-court insolvency processes. This is crucial to attracting investors in the distressed assets market. Cross-border legal and tax issues also play important roles.

### **Public Asset Management Companies as Part of an NPL Resolution Strategy**

When coordinated with private sector initiatives, Asset Management Companies (AMCs) can enhance the recoveries of distressed assets that have been acquired from failed banks and other financial institutions. They can help in the context of a comprehensive NPL resolution strategy for a national economy. By forcing banks to recognize losses and making recapitalization needs transparent, they can help restore confidence in the financial system. They can also improve the asset quality, income, and liquidity of the financial institutions transferring assets, while allowing them to refocus on their primary role: financial intermediation. Political interference is a risk, however, and if poorly designed or managed, AMCs may undermine credit

discipline and generate significant losses for taxpayers. A solid institutional and regulatory environment, robust corporate governance, and strong commercial focus are therefore critical to their success. Public AMCs have been successfully used both in developed countries, including the United States (1989) and Sweden (1993), and more recently in Ireland (2008) and Spain (2012), as well as in emerging economies, including Indonesia (1998), Turkey (1999), and Nigeria (2010), and in many instances have been able to successfully co-exist with private sector initiatives.

### **Attractive Markets for Investments in Distressed Assets**

When investors consider entering a new market, they evaluate and analyze a number of preconditions, the key ones being the market size, the macroeconomic environment, the legal and regulatory framework, the quality of information, as well as the servicing capacity and the investor base. With more than a decade of experience in investing in NPLs globally through DARP, IFC has identified six countries that have met—or are working to put in place—the preconditions for large-scale distressed assets resolution, thus warranting priority focus for investors. These are Brazil, China, Greece, India, Turkey, and Ukraine.

### **Valuable Lessons Learned and Insights**

Having played a key role for over a decade in developing distressed assets markets in emerging

economies, DARP has been able to draw several lessons that can be valuable to all stakeholders in NPL markets. In addition to the preconditions for entering new markets described above, it is also important to have local knowledge, a presence on the ground, close alignment of stakeholder interests, and a commitment to use best resolution practices.

### **Conclusion**

Since its inception, DARP has developed significant experience, knowledge, and tools that have helped create vibrant distressed assets markets across the globe. Yet much remains to be done, especially today as the global economy experiences increasing uncertainty and large volumes of NPLs continue to be a drag on many economies. DARP is well-positioned to leverage its unique global network of partners to attract private sector capital and expertise to continue developing distressed assets markets across emerging economies, while tapping the significant opportunity that these markets represent. DARP is now extending its reach into new regions such as Sub-Saharan Africa (SSA) and the Middle East and North Africa (MENA), as well as further enhancing market development by supporting the creation of secondary markets for distressed assets and promoting the adoption of new technologies to improve the performance of these markets. Through DARP, IFC will continue to play a leadership role in the distressed assets space. ■





## CHAPTER 1

# DARP: Creating Markets to Promote Development and Financial Stability

By Josep M. Julià, Eric D. Cruikshank, and Marta Sánchez Saché

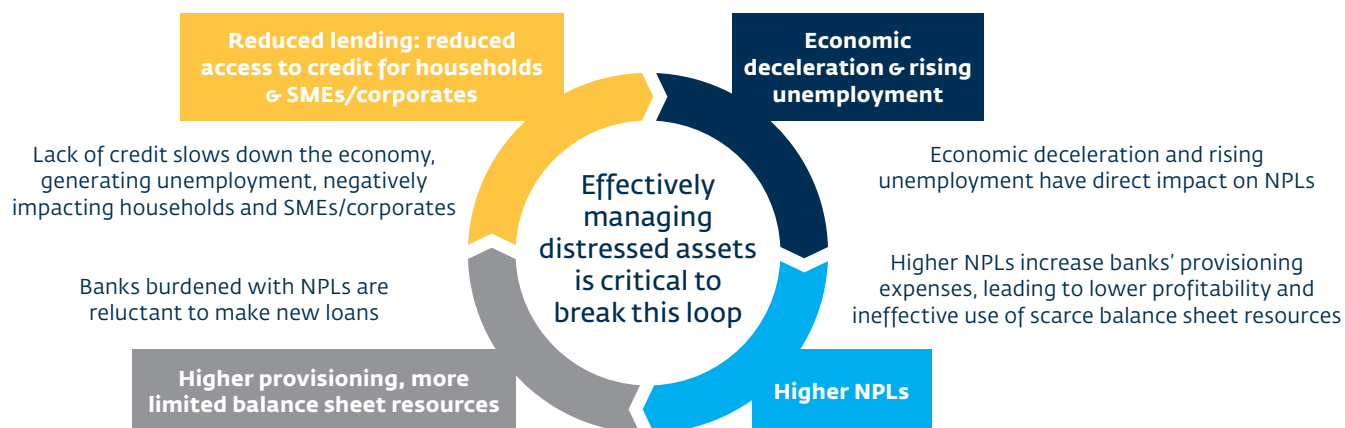
Inherent in all debt is a promise to repay. Yet many things can prevent this promise from being honored and cause financial stress for borrowers, lenders, and even a country's financial system. Therefore, the ability to resolve delinquency of financial obligations of both individuals and companies has a definite financial benefit—not only to the creditor, but also to the borrower through credit repair. There are systemic benefits—in addition to the sum of payment recoveries—when widespread loan delinquencies in the private sector can be resolved on a large scale. These include enhanced economic growth, reinvigorated liquidity, and welfare benefits. These are especially relevant in emerging markets, where private sector debt resolution can improve access to finance for the bottom 40 percent of the population<sup>2</sup> (thus increasing financial inclusion), preserve jobs, and stabilize financial systems. Non-performing loans are an inevitable byproduct of lending. NPLs typically increase with credit

expansion and can be exacerbated in times of economic deceleration. At critical levels, elevated levels of NPLs (in terms of both percentage of gross loans and absolute stock) can lead to reduced lending (see Figure 1.1). This limits credit to productive sectors and to individuals, slowing down the economy and negatively affecting employment. With the resulting drag on output and financial liquidity, cash available for debt servicing declines, leading, via a vicious circle, to more NPLs and thus further rounds of credit and output contraction.

## DARP is Launched in Response to the Growing NPLs in Emerging Markets

In 2006, IFC started to systematically explore how to be an active player and catalyst to stop this negative feedback loop and its adverse consequences for emerging economies. IFC identified several significant

**Economic slowdown and increasing NPLs reduce bank capital and discourage new lending, creating a negative feedback loop.**



**FIGURE 1.1** High Levels of NPLs Lead to Reduced Lending

Source: IFC

positive impacts resulting from the resolution of NPLs, among which (a) banks were afforded an outlet to offload non-productive assets, which enabled them to resume and increase lending, (b) borrowers were able to normalize their obligations and become creditworthy again, and (c) best international resolution practices were transferred across emerging markets—all of these coupled with an attractive financial return.

Subsequently, the global financial crisis of 2008 sparked the formal launch of DARP as an investment platform with global reach. IFC recognized that the crisis posed major challenges for the world's economies, including developing markets, requiring coordinated actions to address liquidity, capital, and asset-quality issues confronting financial systems and institutions. DARP was originally conceived and approved as a three-year investment program to address the increasing levels of debt burden, rollover risk, restructuring needs, and distressed assets in EMs. Its success and its importance for developing stable financial systems, however, allowed DARP to continue well beyond the original investment horizon to the present date, and to become a successful business line within IFC's Financial Institutions Group.

Since then, DARP has played a critical role in the development of NPL markets across emerging economies. In countries where NPL markets and/or insolvency regulation were non-existent or underdeveloped, DARP, jointly with the World Bank, has significantly contributed to creating new, vibrant NPL markets. In other countries with more developed NPL markets, DARP has helped re-activate dormant markets, which, following the crisis of 2008, had lost traction, as many of the traditional investors in this space turned their focus to opportunities in mature markets.

### Close Collaboration within the World Bank Group

A vital component of DARP is the close collaboration with the Finance, Competitiveness & Innovation Global Practice (FCI GP) of the World Bank Group. DARP provides valuable and practical feedback regarding the key elements required or lacking in the insolvency regime of a country. Such feedback is then incorporated in the work that the FCI GP contributes to the efforts to improving the framework for NPL

management. The FCI GP provides advisory work on banking resolution, asset classification, provisioning rules, and collateral valuation, as well as legal and regulatory work on corporate and personal insolvency, foreclosure, debt resolution, and creation of public and private AMCs, which are entities established to manage and enhance recoveries of distressed assets removed from the banking system. The FCI GP also arranges training for court officials as well as for banking industry executives, supervisors, and bankruptcy administrators. Please refer to Chapter 2 for more information on the importance of legal aspects of NPL resolution and to Chapter 3 for more details on the role of AMCs and how they complement the work done by DARP.

### DARP's Strategy: Building Global Servicing Infrastructure and Investment Capacity

DARP aims to create an IFC programmatic response to the increasing levels of debt burden and distressed assets in IFC member countries. As mentioned above, the objective is to facilitate a positive systemic impact by: (a) helping banks offload non-productive assets so they could continue lending, and (b) normalizing obligations to allow many distressed borrowers to regain access to finance. DARP's objectives further call for reducing the roll-over burden, increasing access to funding for viable private enterprises (including restructuring where appropriate), and cleaning up financial systems plagued by a significant build-up of distressed assets. As part of this effort, DARP's strategy has been designed based on two main pillars that represent the biggest bottlenecks for the development of vibrant NPL resolution markets: first, building the much-needed servicing infrastructure in EMs, and second, deploying capital efficiently, including mobilized capital from third-party investors, for the acquisition and resolution of distressed assets.

Servicing infrastructure tends to be scarce in EMs, with a limited number of active players and resolution practices that are often inconsistent with international best practices. In this regard, the first pillar of DARP's strategy focuses on developing a solid servicing capacity, by taking minority equity investments in local servicing firms, and introducing best practices for distressed assets activities among servicing companies,



**FIGURE 1.2** DARP's Global Network of Partners

Source: IFC

and banks. As a result, over the last decade, DARP has established a unique global network of partners that provides an important cornerstone to acquire and resolve distressed assets and a critical building block for developing the servicing infrastructure across EMs. This global network (a) provides the capacity to source new investment opportunities, price and manage acquired distressed assets, compare performance among servicers, and share best practices, (b) helps align interests between IFC and servicers to maximize recoveries and return on investments, (c) allows IFC to encourage the use of best collection practices, and (d) contributes to the development of valuable institutional knowledge within IFC on the valuation and resolution of distressed assets.

The first pillar of DARP's strategy focuses on developing a solid servicing capacity. Servicers that are established partners of DARP differ from many traditional lenders in their asset recovery and resolution approaches. A key difference is the emphasis on credit repair as opposed to value recovery. At the heart of such a resolution approach is the effort placed on distinguishing between borrower's "ability to pay" and

its "willingness to pay." DARP servicers tend to use constructive approaches to determine the capacity of delinquent borrowers to pay, and work with them to reestablish their eligibility for borrowing. Legal means are employed but tend to be used as a last resort or as leverage during negotiations. In addition, servicers have more flexibility when trying to reach settlements with defaulted creditors. Unlike financial institutions, they benefit by avoiding the risk of contaminating the rest of their performing loan portfolio. For example, settlements with even a few borrowers in default involving forbearance or partial debt forgiveness can encourage otherwise performing debtors to default on payments with the intention of seeking similar terms.

From the above, it follows that appropriate efforts towards distressed assets recovery clearly have the potential to mitigate many of the harmful consequences of the excessive buildup of private sector debt (both household and corporate) and to contribute to a reduction in financial sector fragility, enhancing access to finance and spurring economic growth and job creation.<sup>3</sup>

The second pillar of DARP's strategy focuses on stimulating the development of markets by mobilizing and deploying capital for the acquisition and resolution of distressed assets. DARP aims to crowd-in capital to expand the universe of investors for such transactions in EMs. In addition to offering the potential for attractive returns, the countercyclical nature of distressed assets as an asset class offers investors important diversification benefits as an "alternative investment" that correlates weakly with the more liquid assets typically traded in financial markets. The combined capital of IFC and third-party investors provides market participants with the liquidity needed to break the vicious circle described above.

## DARP Approaches

Since 2007, commitments under DARP have successfully grown to over \$7.3 billion globally, making IFC a market leader in distressed assets acquisition and resolution in EMs.

## Types of Interventions

The range of investments that DARP focuses on derives from its dual strategy of developing servicing infrastructure and acquiring and resolving NPLs:

1. **Minority stakes in servicers:** DARP takes minority equity stakes in servicers across EMs to establish long-term partnerships and secure the capacity to source, underwrite, and resolve distressed assets; to align interests; and to transfer best practices. In addition, DARP occasionally provides financing to servicers for the acquisition of distressed assets, which increases their impact and helps develop and strengthen their track record and expertise.
2. **Establishment and mobilization of capital into distressed assets investment facilities:** DARP establishes these facilities to: (a) enable IFC to respond rapidly to distressed assets needs and opportunities, and (b) efficiently mobilize substantial amounts of private capital into this asset class. DARP can structure these investment facilities

### BOX 1.1 Benefits of a Distressed Assets Market

Recently, we witnessed an increasing trend where financial institutions seek to offload their NPLs to specialized investors. There are numerous benefits to a well-functioning and vibrant distressed assets market:

1. For **investors**, a distressed assets market provides access to potentially attractive returns. It can also help diversify their investment portfolios because of the countercyclical nature of this asset class. In addition, in the case of granular, diversified NPL portfolios, recoveries are realized throughout the life of the investment and therefore returns are not dependent on a single monetization event.
2. For **banks**, maintaining a high level of NPLs ties up an institution's capital in non-performing assets, putting pressure on long-term profitability and making it harder to absorb future losses and strengthen capital buffers. In addition, large NPL portfolios force banks to retain higher levels of capital, reducing their ability to provide new credit, which in turn can hinder economic growth as potentially good investments are postponed or abandoned. Furthermore, NPLs are more expensive to manage in terms of time and resources, which also affects the banks' efficiency and profitability.
3. From a **policy** standpoint, a developed distressed assets market provides for an efficient and effective process for cleaning up banks' balance sheets, as it allows for the disposal of NPLs to private investors who bring greater efficiency, expertise, and financing to the workout process. As shown in Figure 1.1, a large volume of NPLs can undermine the reliance on the banking system and erode economic growth.

A well-developed distressed assets market is particularly important during financial crises. Investors can play a valuable role in economic recovery by addressing debt overhang and providing banks with a way to divest themselves of problem assets. As these assets are cleared from the financial system, recovery ensues, and lending and job creation can resume. A distressed assets market also encourages the preservation of distressed but viable businesses, retaining value and generating income. This helps maintain jobs in the economy and preserves the value the enterprise provides to the community. However, despite these benefits, many economies around the world still lack a functioning secondary market for distressed assets.



in different ways, including: (a) generic vehicles that target the acquisition and resolution of NPL portfolios from different financial institutions and credit originators in a country, region, or globally; (b) dedicated vehicles that acquire NPLs from a particular financial institution, as a strategic tool for that financial institution to manage its balance sheet; or (c) transaction-specific vehicles for large, one-off transactions. These different structures can have one or several capital layers (that is, senior and/or mezzanine and/or junior tranches), and DARP can invest across the capital structure. In addition, DARP retains decision-making prerogatives regarding each individual investment made by these facilities.

The type of investments that DARP can make are summarized in Figure 1.3 below:

### Mobilization

DARP has proven to be an effective tool to efficiently mobilize significant amounts of capital for the acquisition and resolution of distressed assets in EMs. As such, the overall level of DARP mobilization has reached almost twice IFC's investment for its own account.

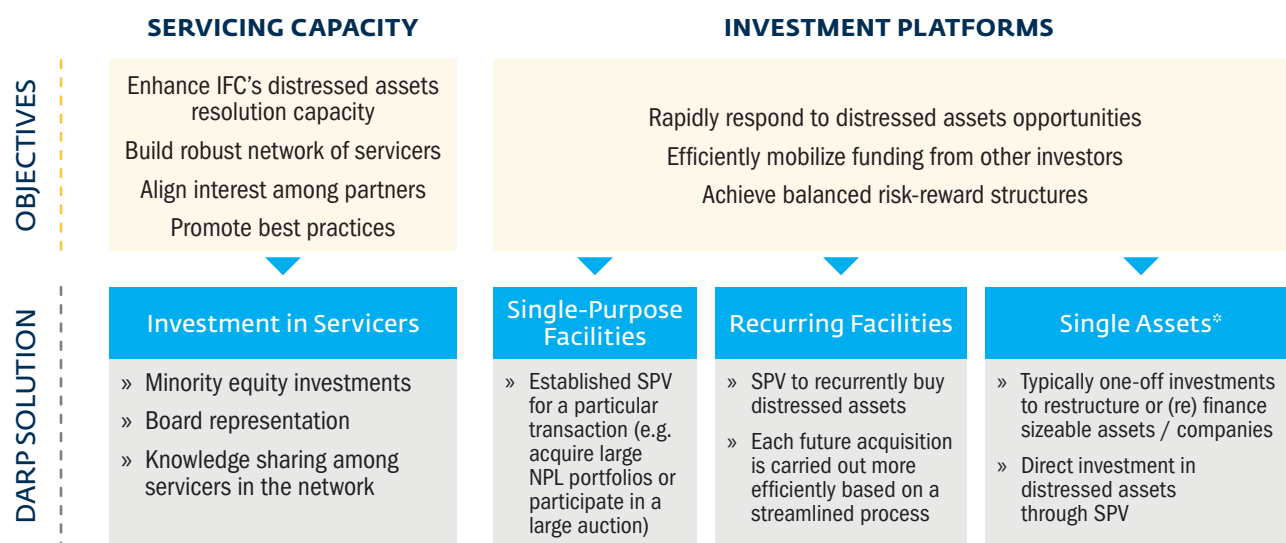
The mobilization approach adopted for DARP draws on: (a) international distressed assets investors

(typically private equity funds, industry funds, sovereign wealth funds, and commercial investors); (b) domestic niche investors; and (c) domestic and international financial institutions.

### Areas of Focus

To achieve its objectives and maximize its development impact, DARP focuses on two main channels:

- 1. Acquisition and resolution of NPL portfolios:** This is the bulk of DARP's business and accounts for approximately two-thirds of the total committed capital. It helps resolve difficulties that credit originators, ranging from banks, non-bank financial institutions and others (for example, retailers or utility companies) face, including high levels of NPLs, reduced lending, balance sheet stress, and poor performance ratios.
- 2. Single Assets:** The second area that DARP focuses on includes:
  - **Special lending:** This focuses on refinancing and mitigating roll-over risk to help maintain market stability and support economic recovery by restoring capital flows, thus improving liquidity and access to finance.



**FIGURE 1.3** DARP's Investments: Building Resolution Capacity and Mobilizing and Deploying Capital

Source: IFC. Note: Single assets include a wide range of investment opportunities, such as special situations, special lending, and corporate turnarounds.

- **Corporate restructuring:** DARP's impact at the company level addresses difficulties stemming from a lack of financing, reduced demand, or pronounced market volatility by: (a) preserving employment, (b) supporting key local/regional entities, and (c) strengthening the company's competitive position.
- **Special situations:** These are investment opportunities that derive from market dislocations and inefficiencies, including, among others, high-yield bond trades, non-core business sales, or legal claims acquisitions.

### Significant Development Impact

Since inception, DARP has had a very relevant development impact in the jurisdictions where it has been playing an active role, providing liquidity, capital, and expertise to the financial and real sectors, while complementing other World Bank Group programs and initiatives where appropriate. Globally, DARP

- has allowed banks to offload more than \$30 billion face value NPLs, thereby strengthening their balance sheets, freeing up capital, generating liquidity, and ultimately recovering much scarce capital, which permitted these banks to continue lending.
- is helping normalize the obligations of about 18 million borrowers (both households and businesses), allowing them to avoid losing their assets (often their homes or key productive assets), regain access to formal credit, and preserve jobs. Banks are less likely to offer solutions that will successfully normalize client obligations for different reasons: (a) banks tend to focus collection efforts on the more recent delinquencies, since resolving distressed assets is not their core business and they seldom have the expertise or the resources to effectively pursue collections, (b) problem-asset resolution involves a significant amount of management's time and attention, and (c) more importantly, banks fear that reaching settlements with defaulted borrowers at a discount can potentially contaminate their performing loan book.
- has fostered best resolution practices for NPLs, including best E&S policies and procedures.

### Strong Market Creation and Development

IFC has played a critical role in the development of NPL markets in the countries where it has made DARP investments. In some countries, like India, Colombia, and countries across the Caribbean and Eastern Europe, DARP has significantly contributed to creating new, vibrant NPL markets. In other countries, where NPL markets were more developed, such as Brazil, the Philippines, or Mexico, DARP has helped re-activate dormant NPL markets, which, following the crisis of 2008, had fallen out of favor with investors, as many of the most active investors switched their focus to opportunities in the United States and Western Europe. DARP's presence and successful track record across EMs has also made it more attractive for new investors, both domestic and international, to consider entering these markets. For example, DARP has been able to attract leading international investors, such as Apollo Global Management, Bain Capital, Fortress Investment Group, and Deutsche Bank, as well as domestic ones, including Itau Unibanco in Brazil and Bancolombia in Colombia.

Despite the progress achieved, much remains to be done, especially in the current environment where the NPL stock in EMs is on the rise. In addition to collaborating with the World Bank to develop solid legal and regulatory frameworks and working with some of the largest banks across EMs to encourage them to dispose of their NPL portfolios, DARP continues to engage with many of the leading international distressed assets investors to facilitate their entry into markets where they hitherto have not been, which will further develop the secondary distressed assets market.

### Valuable Lessons Learned and Insights

With more than a decade of experience investing in nascent distressed assets markets around the world, DARP has been able to identify several key lessons that are fundamental for developing new markets or asset classes.

First, all stakeholders should heed the preconditions required to make a new market viable and attractive, as described in Chapter 4.

Second, it is critical to understand the importance of having strong local knowledge and presence.

Distressed assets are a very local affair, not only because of how the legal and regulatory framework impacts investment and resolution strategies, but also because understanding the idiosyncrasy of a given jurisdiction is crucial for a successful resolution. In that sense, one pillar of DARP's strategy has been to build a global network of local partners that provides IFC with the capacity to source, underwrite, and manage distressed assets.

Third, the ability to closely align the interests of the

various stakeholders is equally relevant. For global investors who must rely on local partners, ensuring such alignment is key for the success of the partnership. This alignment of interests is also critical for other relevant stakeholders such as sellers and regulators.

Finally, using best resolution practices is crucial, not only because IFC and institutional investors need assurance that business is conducted professionally, but also because treating debtors as clients and partners leads to better outcomes and returns.

## BOX 1.2 DARP, Innovation Across Distressed Assets Markets—Part 1

### Latin America: Servicing Infrastructure and Innovative Structures to Develop a Market

#### Background

Following the financial crisis of 1999 in Colombia, a number of local financial institutions went through the process of restructuring their balance sheets and removing their NPL portfolios. The authorities created Fondo de Garantías de Instituciones Financieras (FOGAFIN)—an agency responsible for providing liquidity support to eligible financial intermediaries and assisting in the winding-up of entities that were deemed unable to continue operations—and ultimately, to help stabilize the situation and avoid a systemic meltdown in the economy. FOGAFIN, in turn, created Central de Inversiones S.A. (CISA) to manage the NPL portfolios and the assets received in lieu of payment from the various entities to which it provided credit.

By 2006, the regulators decided that it was time to dispose of the NPLs held by CISA to monetize the assets and recover the funding that the authorities had initially provided. In addition, the regulator identified an opportunity to leverage this process to kick-start the distressed assets market in the country.

#### DARP Solution

In response, IFC decided to initiate a programmatic approach to supporting the development of the distressed assets market in Colombia, implementing the two-pillar strategy. In 2007, as a first step, IFC supported the resolution of the assets held by CISA, which remains the largest NPL transaction in Latin America to date, and which sparked the creation

of a distressed assets market. Later, in 2009, IFC invested in a local specialized servicer, Covinoc, to develop the infrastructure required to acquire and resolve NPLs. In addition, IFC mobilized capital from third-party private sector investors and set up several platforms to buy retail and SME NPL portfolios. In 2010, for example, IFC partnered with Bancolombia, one of the leading financial institutions in Colombia, to provide an innovative, market-oriented, and highly efficient mechanism to put the bank's NPL portfolio back into productive use. In partnership with Bancolombia and Covinoc, DARP established a program to acquire NPLs from the bank on a recurring basis. The platform was capitalized with a total of \$100 million, of which half was provided as a junior tranche by Bancolombia, Covinoc, and IFC. The other half was provided as a senior tranche by Bancolombia and IFC to enhance investor returns and help bridge any potential pricing gap.

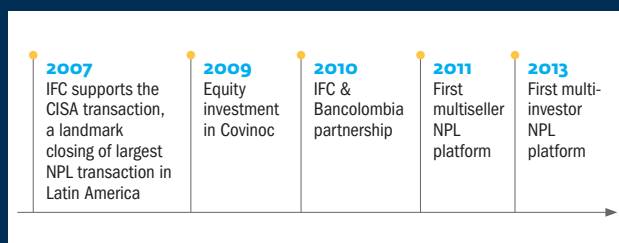


FIGURE 1.4 DARP in Colombia: Timeline

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### **Outcome**

This innovative approach provided Bancolombia with a mechanism to dispose of its NPLs on a regular basis, ensuring the availability of capital and facilitating market pricing. In addition, it allowed Bancolombia to participate in the upside realized on these NPLs. To date, this platform has acquired more than 15 consumer portfolios, helping the bank offload close to \$1 billion in NPLs at face value, and allowed over 700,000 distressed loans from approximately 400,000 debtors to be resolved.

In addition, this type of structure has been replicated with success by many other financial institutions in other markets as an instrument to manage their balance sheets.

### **Asia: A Successful Partnership for Special Lending to Save Stressed SMEs**

#### **Background**

In 2012, Asian markets were seeing an increasingly challenging macroeconomic environment coupled with the broader outflow of foreign investment from emerging markets and diminishing availability of bank lending. This made it extremely difficult for stressed but, importantly, viable SMEs to access traditional sources of debt financing. Without this financing, many of these SMEs would have gone

bankrupt, causing a significant loss of jobs and a negative economic impact.

### **DARP Solution**

To fill the financing gap in emerging markets across the region, IFC partnered with ADM Capital, a leading credit specialist investment manager in Asia. Together with ADM Capital, DARP established an innovative platform of \$100 million, with IFC investing \$50 million as a cornerstone investor. This platform had a capital structure composed 80 percent of a senior revolving credit line and 20 percent of a junior loan tranche with income participation, creating options to mobilize different types of investors seeking different risk/return profiles.

### **Outcome**

The partnership with ADM Capital has been successful because of its development impact and, more importantly, its demonstration effect. Since its establishment, this platform has invested in 33 stressed SMEs and has already successfully restructured 16, helping them to obtain essential capital to meet liquidity and capital expense needs. In addition, this partnership has shown that financing for stressed SMEs can be raised commercially, which has attracted many other investors to these markets.

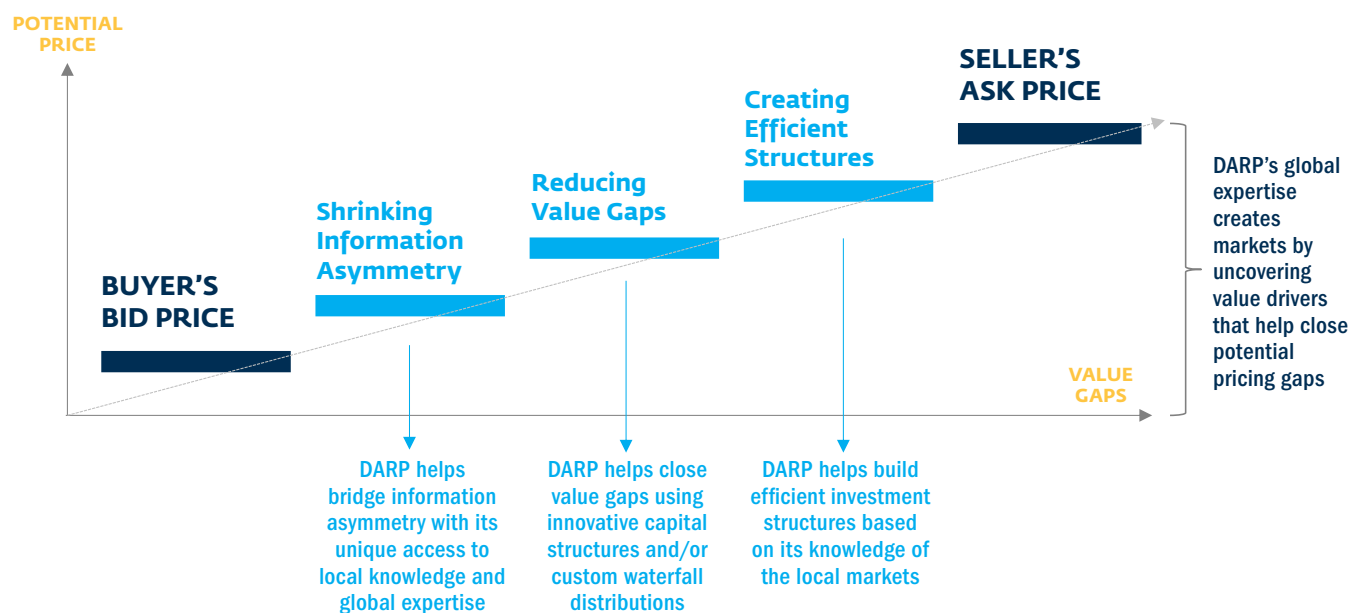
## **How DARP Can Address Market Inefficiencies**

Certain impediments prevent distressed assets markets from functioning efficiently and effectively. DARP has the tools to address and mitigate these impediments so that distressed assets markets in EMs can develop and improve over time.

### **Pricing Gap**

A key challenge in developing a market for NPLs is closing the pricing gap. This is the difference between the price that a prospective seller of NPLs believes their assets should command and what is often a lower price that would convince prospective buyers

that they will be fully compensated for the risk and uncertainty associated with the assets—and for the initially high transaction costs in a nonexistent or nascent market. Pricing gaps can be addressed by reducing information asymmetry, strengthening legal and institutional frameworks, and improving the quality of the servicing infrastructure. DARP, in collaboration with the World Bank Group's Finance, Competitiveness & Innovation Global Practice, contributes unrivalled experience and expertise across markets and asset classes to NPL market creation and development. Identifying and strengthening value drivers facilitates the price discovery function while reducing transaction friction within the context of NPL market development (see Figure 1.5).



**FIGURE 1.5** Bridging the Pricing Gap

Source: IFC

### Underdeveloped Capital Markets and Inadequate Insolvency Regimes

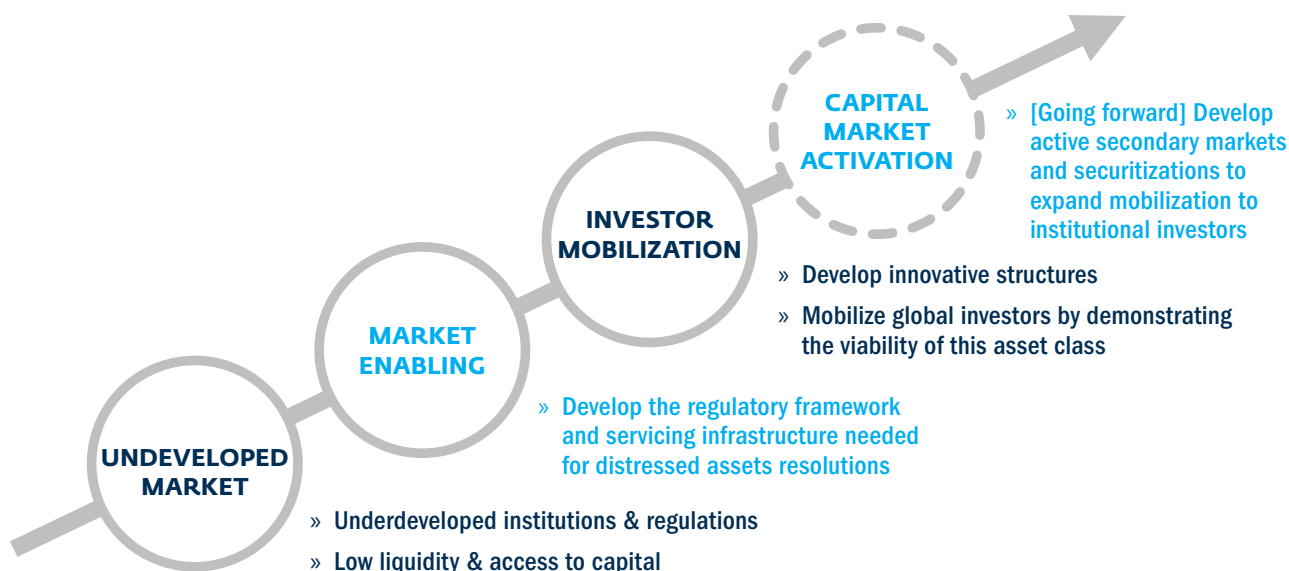
In addition, DARP plays a critical role in establishing both the frameworks needed and the required infrastructure for successful distressed assets markets in EMs, with the objective of ultimately developing the local capital markets to reach the scale necessary to address the increasing stock of NPLs. Along these lines, DARP starts by working with the World Bank Group's FCI GP to help establish the required initial building blocks, such as adequate insolvency regimes, as well as robust servicing infrastructure, which in turn attract leading investors to these nascent distressed assets markets. The objective is to build a track record and generate sufficient data over time so that capital market instruments collateralized by distressed assets can be rated by credit rating agencies. This will attract and enable investment by a broader group of institutional investors such as pension funds and insurance companies (Figure 1.6). As is the case in more developed distressed assets markets such as the United States, the ultimate use of capital markets instruments will permit sufficient capital to be mobilized to provide a permanent funding channel for resolving the growing stock of NPLs.

Appropriate insolvency regimes are particularly important for a nascent secondary debt market and have two main functions: to preserve value and to distribute value. The experience with national insolvency regimes will have an impact on the prices for NPL portfolios that investors are willing to pay. This aspect will, among other things, influence the number and types of potential investors attracted as participants when developing a secondary market for loans generally, and for distressed obligations in particular. Chapter 2 covers some of the main requirements for a robust regulatory framework.

### Information Required for Distressed Assets Investor Due Diligence

Many of the considerations in offering a portfolio of distressed loans for sale are the same as those essential for offering a portfolio of performing loans, but some additional issues need to be addressed.<sup>4</sup> Banks, as distressed assets sellers, must deal with missing historical data regarding exposures, discrepancies between loan documentation and data records, missing or incomplete documentation, breaks or anomalies in the chain of title, flawed data on loan collateral





**FIGURE 1.6** How DARF Can Create and Deepen Local Capital Markets

Source: IFC

and valuation methods, and frequent changes in data sources. Distressed assets investors will want to have information regarding the nature and status of defaults, the history of attempts to enforce the corresponding legal agreements, lender-borrower correspondence, inter-creditor communication history, borrower financial situation, the state of the collateral (if any), and any other information that allows them to adequately understand the risk and forecast a monetization event. One of the biggest challenges, especially present in nascent distressed assets markets, is the lack and quality of the information available for investors to assess their risk and align financial-return expectations.

As part of the due diligence process, it is also essential to uncover any local restrictions on loan transferring and necessary debtor consents that, if ignored, could severely impair the collection process. Loan transfer restrictions can include borrower or co-lender consent requirements, confidentiality or privacy restrictions, consumer protection law provisions, lender minimum-hold requirements, and, if the loan has been syndicated, restrictions related to majority lender and/or administrative agent consent and transference of the agency role.

When loans are secured by collateral, it is important to check the current state and value of the collateral, hidden liabilities (for example, unpaid property taxes), existence of liens that might cap recovery values, state of property titles, and several others. It is important to consider the valuation of collateral in the context of current market conditions, given that the valuations reported by sellers can be outdated.

The use of the legal system to pursue collections is one part of the recovery strategy used in distressed assets. Investors need to develop a good understanding of the local foreclosure laws, especially in terms of timing and costs. The transfer of all legal processes to the buyer of distressed assets ensures that no enforcement rights are lost. It is also critical to make sure that the seller bank provides all relevant legal documentation for all distressed assets being sold to empower the new owner to pursue judicial collections, as well as to enforce available rights and remedies.

Finally, and in the context of all the items discussed above, it is crucial to understand the local particularities of each market and jurisdiction. In short, the better the information provided by the seller, the higher the price the buyer will be willing to offer.

### BOX 1.3 DARP, Innovation Across Distressed Assets Markets—Part 2

#### Eastern Europe: A Landmark Transaction in Romania that Sparked Distressed Asset Markets in the Region

##### Background

The significant stock of NPLs has been an onerous and chronic problem in Eastern Europe since the global financial crisis battered the region. By 2015, despite increased interest of potential buyers, the NPL market in the region was still characterized by a record number of failed transactions. At that time, there was an impending risk that investors would retreat from the region with the fear that NPL sales would not close despite spending significant time and resources. In a region where banks needed to be able to offload their large stocks of NPLs to continue lending operations, the departure of investors could have derailed the prospects for economic recovery.

##### DARP Solution

To show investors that NPL transactions could be successfully closed in Eastern Europe, IFC leveraged its network of distressed assets servicers and investors in the region to create a successful example. Following the failure of a market auction, DARP strove to provide a bilateral solution, resulting in the sale of an NPL portfolio in Romania that was the largest in both the country and the region since the 2008 financial crisis. Together with Deutsche Bank and APS, DARP's servicing partner for the region, IFC purchased an approximately €1.2 billion in face value NPL portfolio of secured micro, small, and medium enterprise (MSME) loans and real estate owned assets (REOs) from Banca Comercială Română (BCR), a large Romanian bank. The successful completion of this transaction was built on IFC's local market knowledge and experience gained through its partnership with APS.

##### Outcome

With this landmark transaction, DARP helped BCR efficiently offload a massive stock of NPLs to complete the bank's restructuring, alleviate its regulatory-capital needs, improve the quality of its assets, and unlock additional lending capacity. Its significant impact included: (a) mobilization of almost €100 million in third-party capital, (b)

resolution of more than 9,000 distressed loans from about 6,000 debtors to date, and (c) a strong demonstration effect as the largest transaction successfully executed in the East Europe and Central Asia (ECA) region to date.

Because of the success of this transaction, NPL sales took off in Romania, as well as in other countries of the region such as Serbia, Croatia, Bulgaria, Bosnia and Herzegovina, and Montenegro.

#### Caribbean: Creating Markets in an Untapped Region

##### Background

The high level of NPLs in the Caribbean is a legacy of the 2008 global financial crisis and the 2009 collapse of CLICO, the largest privately held conglomerate in Trinidad and Tobago, and one of the largest privately held corporations in the Caribbean. Such high NPL ratios result in weak economic recovery—in some countries in the region, they were as high as 20 percent. The region also has inherent challenges (multiple legal and regulatory frameworks, thin servicing infrastructure, geographical dispersion, and small transaction size) for market creation and capital mobilization, as each standalone country does not have the critical mass to attract investors. The lack of a distressed assets market constrains access to finance and credit and intensifies the region's vulnerability to shocks.

##### DARP Solution

Since 2010, DARP has been working closely with the World Bank and the International Monetary Fund (IMF) to establish the basic building blocks of a distressed assets market in the Caribbean. Finally, in 2018, DARP engaged Adamantine, a Mexican NPL investor and servicer, to launch a \$150 million DARP platform to purchase NPLs in the Caribbean. This came after several attempts across the region to mobilize other investors, including the creation of a "bad bank"<sup>5</sup> for the Organization of Eastern Caribbean States. This new DARP platform succeeded in mobilizing a private sector distressed assets investor to deploy capital in this region for the first time. One result is that previously inactive sellers have been encouraged to offload NPLs. As a

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result, a track record of successful transactions is developing that will promote an active distressed assets market capable of attracting capital from other investors. For example, this platform helped Scotiabank in the Bahamas reduce NPLs by over 90 percent through NPL portfolio sales.

#### **Outcome**

This platform, the first of its kind in the region, has already made significant strides. To date, it has acquired 19 portfolios in 12 countries, allowing banks to offload over \$300 million of NPLs and

helping normalize the obligations of about 30,000 debtors, both individuals and SMEs. In addition, 23 percent of the capital was mobilized in IDA countries (St. Lucia, Dominica, Grenada, and Guyana).<sup>6</sup>

The work of IFC's advisory group and the World Bank on credit bureaus and collateral registries is one example of how harnessing the combined efforts of DARP and the World Bank can dramatically reduce financial sector fragility, enhance access to finance, and spur much-needed economic growth and job creation.

## **DARP Milestones and Achievements**

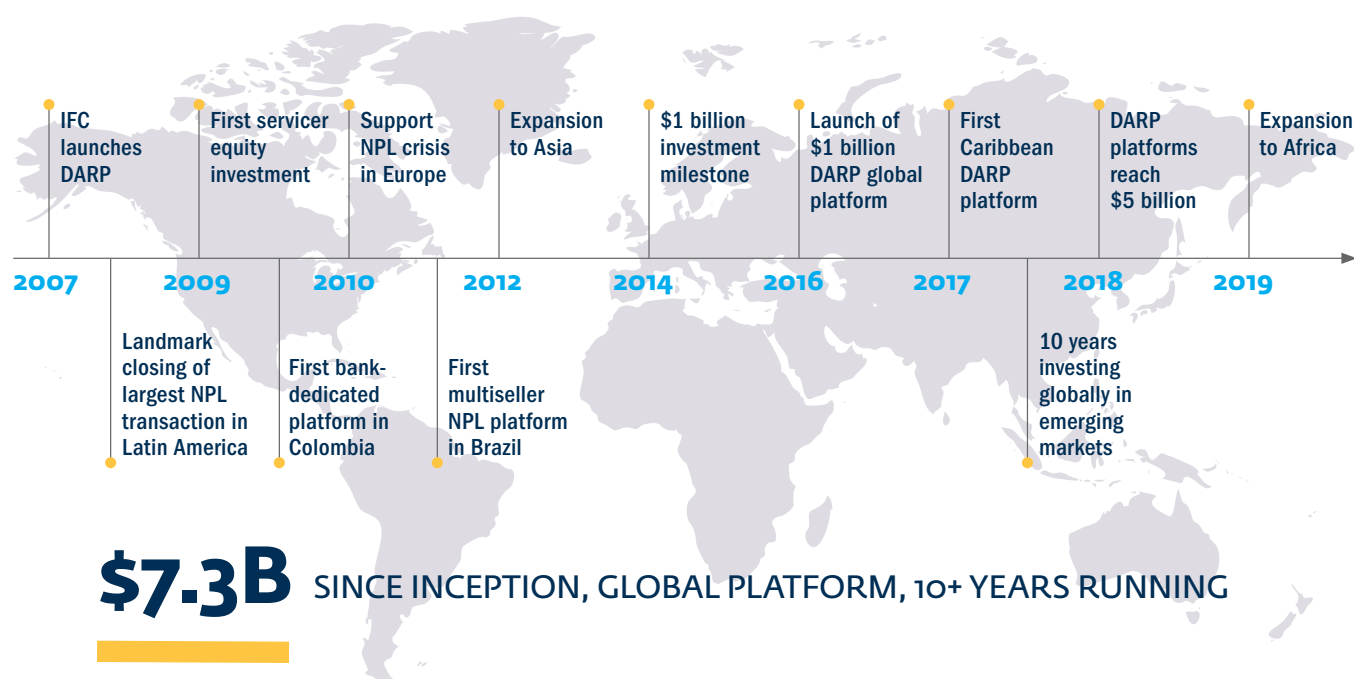
Since its inception, DARP has continually expanded its reach geographically, from its origin in Latin America to the current coverage in Asia, Eastern Europe, MENA, and Sub-Saharan Africa. Figure 1.7 presents the evolution of DARP from its earliest transactions in Latin America to its present-day status as a global catalyst for distressed assets markets.

DARP has had a significant role in the creation and development of many distressed assets markets across EMs by bringing innovative transaction structures and solutions to the marketplace. For example, in 2006 DARP helped facilitate the largest-to-date NPL transaction in Latin America by acquiring the entire NPL portfolio from a Colombian “bad bank,” as explained in Box 1.2. This transaction kick-started the creation of a market that evolved into one of the most sophisticated in the region. In 2009, DARP made its first equity investment in a servicer, putting in place the foundation for what today is a unique global network of partners across emerging market countries. Later, in 2012, DARP established the first multi-seller NPL platform in Brazil that grew to become the market leader and played a pivotal role in attracting several entrants to the market.

By 2014, DARP had already committed \$1 billion for IFC's own account and mobilized more than \$2 billion from third-party investors. In 2016, DARP established the first global NPL platform, in

partnership with Apollo Global Management, to expand and maximize its impact across emerging economies. In 2017, after a long collaboration with the World Bank and the IMF, DARP established the first NPL platform in the Caribbean, a region in dire need of a resolution mechanism for its increasing stock of NPLs. Later, in 2018, DARP played a critical role by establishing the first platform focused on resolving corporate distressed assets in India, with a significant demonstration effect regarding the implementation of a fully revamped new insolvency code. More recently, in early 2019, DARP established its first regional platform in Sub-Saharan Africa, which is an important milestone in developing the NPL market in the region as it provides a solution unavailable until now to many local banks.

DARP's global expansion has been facilitated by its strong financial performance and outstanding developmental impact. With actual total commitments to date of more than \$7.3 billion, including \$2.7 billion from IFC's own account and \$4.6 billion from third-party investors, DARP has secured its global leadership role as a distressed assets investor in emerging markets. Since inception, DARP has acquired more than 150 NPL portfolios, ranging from retail unsecured to corporate secured NPLs, as well as mortgages and commercial real estate-backed NPLs. Some of these achievements are summarized in Figure 1.8.



**FIGURE 1.7** DARP Key Milestones, 2007–19

Source: IFC

# Portfolios Acquired	UPB	# Borrowers	Mobilized Capital
<b>150+</b>	<b>\$30+ Billion</b>	<b>18+ Million</b>	<b>\$4.6 Billion</b>
» Acquisitions of NPL portfolios across asset classes in Latin America, Eastern Europe and Asia	» NPLs offloaded from multiple lenders, increasing liquidity and origination of new loans	» Individuals and SMEs able to avoid losing their assets and remain active in the financial system	» Mobilized from third party investors, deepening secondary markets with improved liquidity

**FIGURE 1.8** Selected DARP Results

Source: IFC

## DARP Going Forward

DARP has made significant contributions to distressed assets and capital markets development during its brief existence. Yet much remains to be done. Three areas that warrant concerted effort in the future are: (a) expanding DARP's reach in underserved regions such as SSA and MENA, (b) providing further market development by supporting the creation of a secondary market for distressed assets that will accommodate *inter alia* the securitization of pools of loans and other distressed assets (including real estate and other physical assets used as loan collateral), and (c) leveraging potential synergies with Fintech initiatives.

### Expansion in Sub-Saharan Africa and the Middle East and North Africa Regions

After starting in the Latin American region where it established a strong presence and then extended activities to Eastern Europe and Asia, DARP is now focusing on the untapped market potential of undeveloped distressed assets markets across SSA and MENA. These two regions have many countries that could materially benefit from a dynamic distressed assets market, provided that the requisite groundwork is laid. Priorities in these markets are: (a) collaborating with the World Bank to develop sound legal and regulatory frameworks, (b) establishing a solid debt-service infrastructure, and (c) mobilizing dedicated capital. In SSA, after having successfully established its first regional platform, DARP is focusing its efforts on effectively helping banks offload their NPLs, as well as expanding its reach into other less-developed markets in the region. DARP has also explored possibilities in Nigeria—the largest economy in Africa—and will continue this effort to address the needs of the region. In MENA, DARP has established the first NPL resolution platform of its kind, which initially focuses on Pakistan, Egypt, Lebanon, and Morocco. This has been a joint World Bank-IFC effort, which ensures that the insolvency regime and servicing capacity are in place to attract investors interested in investing in distressed assets.

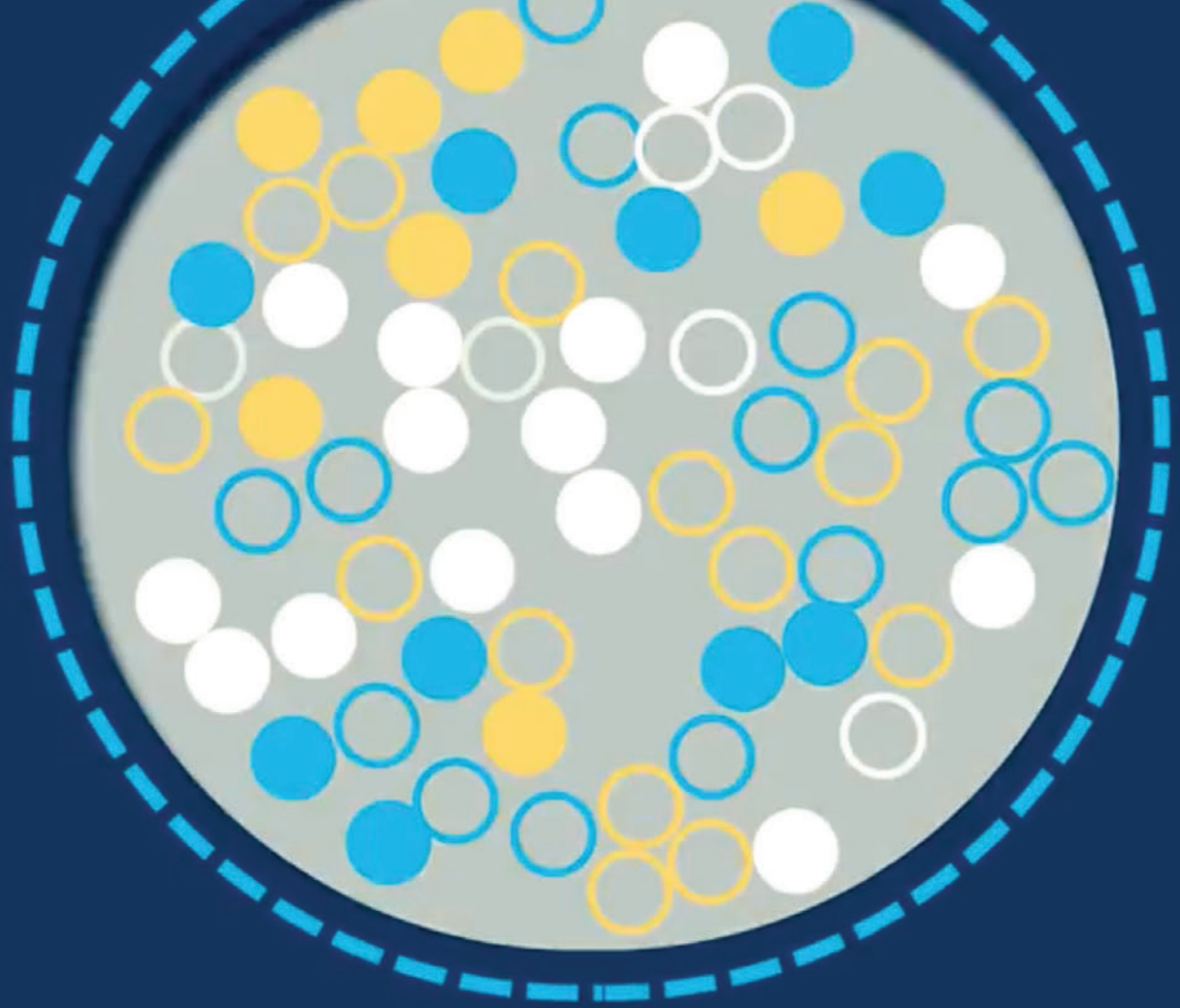
### Securitization and Secondary Markets

In markets where DARP has played a role establishing an NPL track record, the priority will be to continue supporting the creation of a secondary market for distressed assets. This could be addressed through securitization transactions involving pools of NPLs, either from credit originators (such as banks, other financial institutions, retailers, and public utilities) or from other investors such as those that have previously acquired NPL portfolios, a portion of which they may be prepared to sell. Through securitization, the liquidity available for the asset class will increase, which in turn should stimulate additional interest from new and existing investors. The need for an active secondary market is key to maintaining an active investor base to ensure a consistent demand for distressed assets.

### Fintech

As distressed assets markets develop within emerging markets countries, servicers are increasingly adopting tools enabled by recent technologies that were unavailable just a few years ago. By applying digital engagement and artificial intelligence, they are making vital strides to improve performance. Despite the growing awareness of this potential, this area has just begun to be developed and substantial efficiency improvements have yet to be realized. Digital engagement provides servicers with additional channels to connect with debtors and clients, allowing them to tailor their resolution and recovery strategies to clients' specific needs. Artificial intelligence affords servicers the opportunity to leverage existing data to materially improve their pricing models and enhance collections. Furthermore, many fintech companies are generating loan portfolios which, in part, as they mature, will result in NPLs. DARP will seek to work with these fintechs to help them manage their balance sheets, as it does with other credit originators. To this end, DARP has begun to work with IFC's Fintech team to sharpen its strategic approach in this area. ■





## CHAPTER 2

# The Legal Framework Behind a Distressed Assets Market: Insolvency, Enforcement, and Workouts

By **Andrés F. Martínez**

Over the past decade, we have seen a large and dynamic market for distressed assets develop that represents a relatively small but important sector within the investment community. Investors can purchase these assets at a significant discount because of their inherent risks, which creates the potential for attractive returns. Given the countercyclical nature of this market, in which opportunities appear as an economy slows, the most fruitful period for investors is typically during or following a financial crisis.<sup>7</sup>

Generally speaking, there are two prevalent strategies among investors engaged in the distressed assets market.<sup>8</sup> The first is to purchase these assets with the goal of accumulating a significant position in a company that is either insolvent or on the verge of insolvency. The second involves the trading of distressed debt. Transactions in this market may involve the purchase of distressed debt securities and/or NPLs, which may be sold or securitized into instruments composed of multiple retail and/or corporate loans. This debt is purchased at a discount to face value under the assumption that the face value is overvalued relative to its fundamentals. The discount that the investor will apply will depend on the investor's return expectations and expected ability to enhance the debt's value through negotiations in the resolution process, either through the enforcement of the debt or by profiting from the piecemeal liquidation of non-core assets. In either of these strategies, the legal and institutional aspects play a key role.

Effective legal and institutional regimes help maintain a risk level that is acceptable for distressed assets markets to develop. The insolvency regime, the enforcement system, and the environment to achieve out-of-court workouts are essential when looking at distressed

assets investments.<sup>9</sup> This is partly because the expected, and eventually realized, returns of this asset class are a combination of the investor's ability to unlock the intrinsic value of the asset, the risk premium for holding the asset, and the liquidity premium—given that distressed assets are generally relatively illiquid investments. The risk premium is, in turn, composed of various market factors (such as valuation risk). However, one of the most prominent factors is the legal regime upon which the monetization of the asset relies. Although distressed assets markets are becoming increasingly global, local laws and regulations—and their practical application—can have a significant impact on investor returns.<sup>10</sup> Laws and regulations that favor smooth transactions and loan transfers allow investors to enforce their claims and collateral efficiently and provide mechanisms for both out-of-court restructuring and efficient in-court insolvency processes that are crucial to attracting investors in any given distressed assets market.

## The Legal Framework Behind a Distressed Assets Market

Investments in distressed assets are primarily attractive for their substantial return potential, which is derived from the risk undertaken by the investor. However, there is a tipping point when even a highly discounted offer price comes with too much risk and uncertainty. At this point, even the most aggressive, risk-bearing investors will withhold investment in the asset because of the level of risk. This is where the legal and institutional factors related to insolvency and financial distress come into play.

The legal challenges that an investor may encounter are many. Examples of threats to the smooth functioning of distressed assets markets include:

- Regulatory challenges related to NPL portfolio purchases (for example, requirements of a financial entity or unfavorable tax treatment)
- Requirement of the ultimate debtor's consent to transfer purchased assets
- Difficulties in enforcing the debtor's assets in an extra-judicial or judicial process (either because of weak laws or because of poor enforcement) and procedural barriers in transferring ongoing enforcement actions to purchasers of the claims
- Poor collateral legislation and/or malfunctioning registries
- Difficulties in restructuring a company due to impediments in the insolvency system or in tax legislation
- Difficulties in restructuring a company due to the lack of capacity of key local players such as insolvency practitioners or judges
- Challenging consequences in cases of liquidation, which frequently occur due to unclear repayment priorities—for example, privileged creditors (such as government tax and employee wage claims) may have priority over other creditors
- An environment un conducive to workouts
- Central bank (or supervisory) regulations that discourage distressed asset sales

The roots of the distressed assets market can be traced back to changes in legal and institutional frameworks surrounding insolvency. Although investing in distressed assets goes back centuries, only after reorganization procedures were introduced worldwide (as opposed to the concept of insolvency processes equaling liquidation) did the distressed assets market really take off. Some commentators have identified the passage of Chapter 11 of the United States Bankruptcy Code in 1978 as being a key trigger.<sup>11</sup> It is essential that insolvency systems encourage reorganization so that financially distressed but viable companies can continue to operate, while at the same time aiming to maximize returns for creditors.

Some of the key issues that relate to the importance of the legal system for the development of the distressed assets markets are listed below.

## Debt Enforcement

Legal systems should enable debtors to borrow against their assets and ensure that creditors can successfully enforce against those assets in case of default. This is not only essential for a credit market, but also for the development of the secondary debt market. Distressed assets markets are unlikely to thrive in a jurisdiction with a poorly designed enforcement system that hinders orderly and efficient debt resolution. Such a system would diminish any realistic prospect of capitalizing on the asset. Having effective debt enforcement mechanisms requires that all elements of the framework (legal, tax, regulatory) are mutually reinforcing and work in sync to arrive at a timely, efficient, and cost-effective resolution. Moreover, it relies on a strong institutional infrastructure with an independent and competent judiciary that applies the law in a fair, transparent, predictable, and consistent manner.

In most legal systems there are several avenues for enforcement that creditors can pursue depending on the situation. Two stand out: (a) enforcement outside of court—if the original contract or a written agreement allows, provided there is a statutory provision permitting this type of enforcement; or (b) enforcement through judicial proceedings or some sort of compulsory enforcement services (that is, administrative tribunals or notaries). Enforcement is most effective when parties can agree on the rights and remedies upon default through out-of-court enforcement. This expedites the enforcement process and preserves the value of the asset. Importantly, regulators should seek to remove impediments, such as having foreclosures that rely heavily on cumbersome judicial procedures, complex procedural requirements for auctions, or deep-rooted cultural traditions that hinder the adoption of purely out-of-court enforcement mechanisms. According to the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes, “A modern, credit-based economy requires predictable, transparent and affordable enforcement of both unsecured and secured credit claims by efficient mechanisms outside of insolvency, as well as a sound insolvency system. These systems must be designed to work in harmony.”<sup>12</sup>

Beyond the legal aspects, there are multiple institutional aspects that also play a significant role.

In countries where bailiffs oversee enforcement, it is paramount that they are adequately trained, supervised, and remunerated. In countries where the bailiffs are to be paid in advance, it is essential that there are carrots and sticks in place (via the introduction of adequate incentives) to compel them to perform their job competently and fairly.

## Out-of-Court Workouts

Out-of-court workouts are non-judicial processes that allow debtors and creditors to negotiate restructuring arrangements outside of formal insolvency proceedings.<sup>13</sup> OCWs may be purely contractual or may involve some degree of judicial intervention. The latter, often referred to as “hybrid” procedures,

combine the advantages of both formal and informal procedures and are an efficient alternative or a useful complement to purely formal insolvency proceedings.<sup>14</sup> OCWs thrive outside of the judicial system but rely on an effective insolvency and creditor rights system to provide the backdrop against which any workout can be achieved. Effective enforcement and insolvency systems can provide indirect incentives or persuasive force to achieve reorganization.<sup>15</sup> Under the right conditions, OCWs allow for a quicker resolution of distressed assets, leading to reduced costs and better recovery rates for creditors. From a policy standpoint, OCWs help avoid overburdening the judicial system, which is particularly important during financial crises, when corporate distress and NPLs are high.

### BOX 2.1 The London Approach

The London Approach, developed by the Bank of England, has influenced the evolution of government-sponsored OCWs.<sup>16</sup> The objectives of the London Approach are to minimize losses through coordinated negotiations and avoid the unnecessary liquidation of viable companies.<sup>17</sup> The approach provides informal guidelines that enable a collective process to restructure<sup>18</sup> and has been used as a basis for countries to develop their own formal and informal guidelines that encourage OCWs. Since its conception in the 1970s, this approach has been complemented by other instruments that guide OCWs, including INSOL International's *Statement of Principles for a Global Approach to Multi-Creditor Workouts II*, the World Bank's *A Toolkit for Out-of-Court Workouts*, as well as selected sections of the World Bank's *Principles for Effective Insolvency and Creditor/Debtors Rights System*, and the UNCITRAL *Legislative Guide on Insolvency Law*.

More detailed guidelines on OCWs have been introduced in various forms in countries including Indonesia, South Korea, India, and Turkey. They establish principles for debtors and creditors to follow through the restructuring process. The result is a more formalized approach than the London Approach, one that relies on regulatory forbearance, the provision of central bank liquidity, and the regulator's power of “moral suasion” to encourage OCWs on the part of banks in accordance with a loose set of unwritten and/or informal rules.

Under the London Approach most of the form, structure, and industry practice of OCWs was developed by private sector participants themselves (with the role of the U.K. Central Bank/regulator being limited to encouragement and facilitation rather than creating a formal legal framework).

While the London Approach was considered successful in the specific context of the United Kingdom, one of its shortcomings is that its guidelines are purely voluntary and that banks decide whether to participate on a case-by-case basis. In some countries, where similar non-binding guidelines were put in place by the regulator, banks disregarded them and continued to act in their own self-interest. Given these shortcomings, regulators in other countries have turned to legally “enhanced” forms of the London Approach to resolve the problem of “holdouts” (dissenting minority financial creditors). These approaches relied on either a legal basis or inter-banking framework agreements with legal effect that are likely to help overcome issues related to banks failing to cooperate with one another or “holding out.” Encouraging and setting up an approach of this nature can thus increase the likelihood that companies will restructure debt and the quality of the agreed restructuring. Regardless of the technical differences among well-functioning OCWs, investors require an effective in-court insolvency system should OCW mechanisms fail.



This less-formal option for restructuring encourages debtor-creditor cooperation and contributes to the development of a rescue culture, which provides greater opportunities for all stakeholders involved to benefit from an optimal outcome.

Giving investors the opportunity to reach agreements to resolve or restructure their assets outside of formal insolvency proceedings is the linchpin of a distressed assets market. An essential objective for policymakers is thus to create a framework that facilitates out-of-court restructurings that are timely, fair, and reliable.<sup>19</sup> Such a system requires legislative and regulatory frameworks that are comprised of measures conducive to workouts.

## An Effective Insolvency and Creditor/Debtor Regime

An effective insolvency regime lays down the foundation for building a viable distressed assets market. It provides a robust framework and a time-bound roadmap that allows investors to deal with their distressed assets. The recognized best practices described below are intended to help regulators to establish an effective and efficient insolvency framework that will facilitate distressed assets markets. These have been derived from the Insolvency and Creditor Rights (ICR) Standard, developed by the World Bank in conjunction with the United Nations Commission on International Trade Law (UNCITRAL).<sup>20</sup>

**An insolvency system should promote the use of reorganization to maximize the value of the underlying assets.** Reorganization provides investors with a greater variety of tools to maximize the value of the non-performing assets and thus achieve better outcomes. The value is derived from the ability to keep the essential components, both tangible and intangible, of an asset together rather than disposing of it in fragments. Since bankruptcy law was traditionally designed with a “punishing” spirit towards the debtor, many outdated laws still do not fully envisage an appropriate path for reorganization, with the most salient features (for example, commencement of insolvency process, automatic stay, debtor-in-possession (DIP) financing, relief and adequate protection for

secured creditors, majorities and cramdown for plan voting, and effective treatment of executory contracts). If successful, reorganization allows investors to realize higher returns through either the continued operation of a reorganized and more valuable asset, or through its sale (including the sale of restructured debt obligations, newly-issued securities and/or sale of its currently-held securities). The advantages of the reorganization process must be balanced with the advantages of near-term debt collection through liquidation.<sup>21</sup> The possibility of reorganization as an alternative to liquidation should be provided to investors in situations where the value to be derived through reorganization is greater than what they would receive through liquidation (the “no creditor worse off” rule).

**The imposition of a stay can prevent the premature dismemberment of a debtor’s assets.** The application of this stay facilitates the continued value-generating function of these assets and provides breathing room so that interested parties can evaluate the situation and develop a plan of action. Moreover, the system should have a defined mechanism in place that permits the injection of capital to the distressed company to ensure its continued viability, even after the insolvency proceedings have begun (DIP financing). For this to be possible, significant protection should be given to the lender or investor that provides the capital. The system can provide certainty by respecting the pre-existing security rights and priorities of creditors, while granting priority for fresh money injected into the distressed company. Similarly, achieving the objectives of maximizing the value of the asset and allowing the asset to survive may also imply allowing for the interference in the performance of contracts. This may involve allowing an insolvency representative to take advantage of beneficial contracts that contribute value to the estate and reject those that are burdensome (except in situations where performance or rejection of the contract is contrary to public policy).

**The system should also include provisions that allow the insolvency representative to avoid certain transactions retroactively** from a specific date (look-back period or “suspect” period) so that unfavorable or fraudulent transactions can be overturned. This protects investors by preserving the integrity of the insolvency estate and ensuring that the collective effort



results in a fair allocation of the proceeds from the distressed asset. Creditor committees must be formed to represent the interest of the creditors. The priority of claims using a predictable and established process must be respected with equitable treatment of similarly situated creditors.

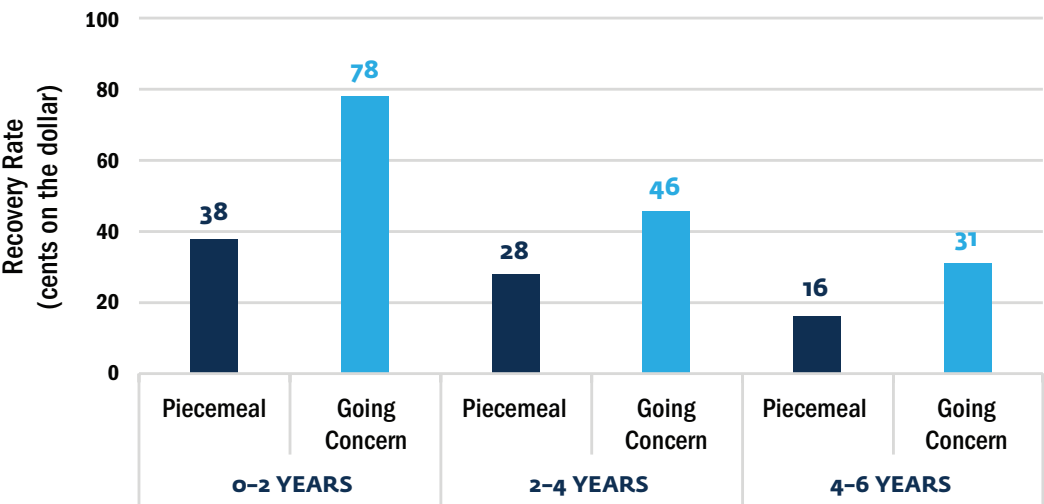
**The insolvency framework should provide for efficient conversion between the different types of proceedings,** where appropriate, so that if reorganization fails, an efficient and effective liquidation will ensure that investors are able to recover some value. Some critical elements of an effective reorganization scheme include providing a structure that encourages fair negotiation of a commercial plan and a platform where the plan can be voted on and approved if accepted by an appropriate majority of creditors.<sup>22</sup>

**An effective distressed assets market requires an insolvency system that is predictable, timely, impartial, efficient, and cost-effective** to maximize the potential returns to investors, increase liquidity, and promote investment. Delays in insolvency proceedings impact the recovery potential of distressed assets, as costs escalate and outcomes are limited. The longer a business is in distress, the more the asset value declines. This is because capital flees, business ties break, and brand equity deteriorates. This loss of value eventually results in a situation where piecemeal liquidation of the asset becomes the only option, which in most cases

means that the investor recuperates only a fraction of the investment. The recovery value from the piecemeal liquidation is, in the great majority of cases, lower than it would have been under a going-concern sale. Similarly, the more extended the insolvency period drags on, the lower the potential recoveries. A look at the average recovery rate in over 190 countries, based on time and outcome, shows that while going-concern sales yield higher recoveries than liquidations, both yield lower recoveries over time and, eventually, liquidations become the only option (Figure 2.1).<sup>23</sup>

**The Importance of Cross-Border Insolvency**

Lastly, in today’s globalized economy, special attention should be given to cross-border dimensions. There are notable differences in the insolvency regimes of individual countries, which may significantly impact a transaction. Knowledge of what laws and procedures apply is particularly important when the distressed situation has a multinational dimension. Investments in distressed assets abroad require investors to perform due diligence on the legal regime and, if necessary, price the heightened risk presented from a lack of effective legal, regulatory, and institutional frameworks. Fortunately, some instruments have been developed in the field of cross-border insolvency that provide



**FIGURE 2.1** Recovery Rate Based on Time to Resolve Insolvency and Outcome

Source: *Doing Business* 2019.

more predictability to investors and assist regulators in developing frameworks to address cross-border dimensions. This includes the UNCITRAL Model Law on Cross-Border Insolvency, and European Union (EU) Regulation 2015/848 on insolvency proceedings.<sup>24</sup> These laws and regulations focus on encouraging cooperation and coordination among jurisdictions to ensure a more efficient and certain process, rather than attempting to unify the substantive law of different countries. Legislation based on the UNCITRAL Model Law on Cross-Border Insolvency, for example, has been adopted by 44 countries.<sup>25</sup> It assists in identifying the laws and procedures that will apply to the transaction (through the center of main interest principle) and helps to determine which person or entity has the legal authority to sell the debtor's assets. As states continue to adopt legislation based on these instruments, it is expected that distressed assets markets will continue to develop by providing greater certainty surrounding the insolvency process in today's globalized environment.

Beyond procedural coordination, there are also some early attempts to unify substantive insolvency legislation around the world. The latest attempt to homogenize certain insolvency aspects comes from the "Directive of the European Parliament and of the Council on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt, and amending Directive (EU) 2017/1132" (Directive on Restructuring and Insolvency). This Directive, once implemented by the member states, will have a direct impact on the market for distressed assets (for example, the mandatory three-year discharge will directly impact retail loan distressed operations). ■

## BOX 2.2 Regulatory and Tax Impediments

Tax impediments may act as barriers to the efficient transfer and resolution of distressed assets. As a result, policymakers should seek to tailor their tax measures to promote the effective resolution of distressed assets. Although tax regimes vary by jurisdiction, there are two key impediments which are common to many countries around the world. First is the ability of banks to take tax deductions for write-offs and provisions on loans, and the ease with which those deductions can be taken.<sup>27</sup> The second relates to the ability of banks to utilize losses from provisions and write-offs and offset them against future taxable income.<sup>28</sup> Change of ownership restrictions and time limits on a bank's ability to carry these losses forward will impact the transfer of NPLs from banks to other entities. Regulators should thus consider making their tax regimes more favorable to investments in distressed assets by removing these impediments. Other tax impediments to consider include other transfer taxes (such as stamp duty and real estate taxes) and the withholding of tax on interest.<sup>29</sup> Another critical tax issue is the income tax that the debtors must pay in the case of debt reductions (haircuts). Often, the income tax in these cases is asymmetrical when looking at the insolvency system and the out-of-court restructuring framework. This may encourage more "judicial reorganizations" while discouraging OCWs (when tax income applies if restructuring is out of court, vis-a-vis an in-court exemption).

## CHAPTER 3

# Public Asset Management Companies

By Caroline Cerruti

## Introduction

by Eric D. Cruikshank

In the World Bank policy brief<sup>30</sup> that constitutes the core of this chapter, we take an in-depth look at situations where national authorities are faced with systemic financial distress and how the use of public asset management companies, or AMCs, can be an effective tool to help address financial crises and resolve the attendant elevated level of NPLs, especially when they complement private sector solutions. An AMC is an entity established to acquire distressed assets from financial institutions with excessive levels of NPLs, particularly banks, with the objective of managing and enhancing recoveries from these assets.

Properly designed, the launch of one or more AMCs in a market can promote a healthy symbiosis between public sector and private sector initiatives dedicated to asset resolution during a financial crisis. Successful examples of AMCs, such as the Resolution Trust Corporation (RTC) in the United States during the Savings and Loans crisis of the 1980s, Sweden's experience of the 1990s with its "bad bank," Securum, or, more recently, the National Asset Management Agency (NAMA) established in Ireland in 2008, or Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (SAREB) in Spain in 2012, are testimonials in support of this assertion. Scrutiny is warranted, however, as to how an AMC can potentially affect either ongoing or intended private sector initiatives, including those supported by DARP. Simply requiring that an AMC should run on commercial principles may not be enough to address this issue. Even with the best of intentions to value and transfer assets at market prices, there is unavoidably a "public-good" element involved with establishing and operating an AMC that has the potential to distort the market and its price levels. Therefore, governance of the AMC and enabling environment (such as robust prudential standards on credit underwriting, risk management,

provisioning, and valuation) are equally critical to develop a distressed assets market.

The recent examples in Europe show how public and private asset management initiatives can strengthen each other with a conducive enabling environment. These public AMCs were established at a time when their distressed assets markets were not developed enough to cope with the large stock of NPLs. The establishment of these AMCs, in combination with a number of regulatory measures taken, resulted in the creation of fertile ground for private distressed managers to enter these markets. These regulatory measures included, among others, the supervisory responsibility assumed by the European Central Bank to (a) increase transparency and uniformity around asset valuation and banks' financials, (b) strengthen prudential regulations, and (c) reform the insolvency procedures in several countries. AMCs by themselves are not always the answer, and in countries where preconditions for an AMC were not met (such as Greece), a strong supervisory approach to reduce NPLs is starting to attract private players.

Therefore, to ensure a public AMC can also enable—and not hamper—private sector solutions, the following questions should be considered:

- If public AMCs are confined to countries and situations characterized by financial crisis, what is the appropriate metric for suitably determining a "go/no-go" decision?
- If private sector solutions are already playing a role in resolving distressed assets, is there a risk that the creation of a public AMC produces unintended consequences?<sup>31</sup>
- Are there ways to safeguard the potential symbiosis between AMCs and private sector initiatives, especially where the latter already have ongoing operations (other than merely relegating their activities exclusively to a role of buying AMC portfolios)?

In addition to the examples mentioned above, over the years several emerging economies have established public AMCs, including China, Indonesia, Malaysia, Nigeria, Turkey, and Vietnam. Currently, other countries, such as Bangladesh and India, are also considering setting up their own public AMCs. As they do so, the questions above should be considered.

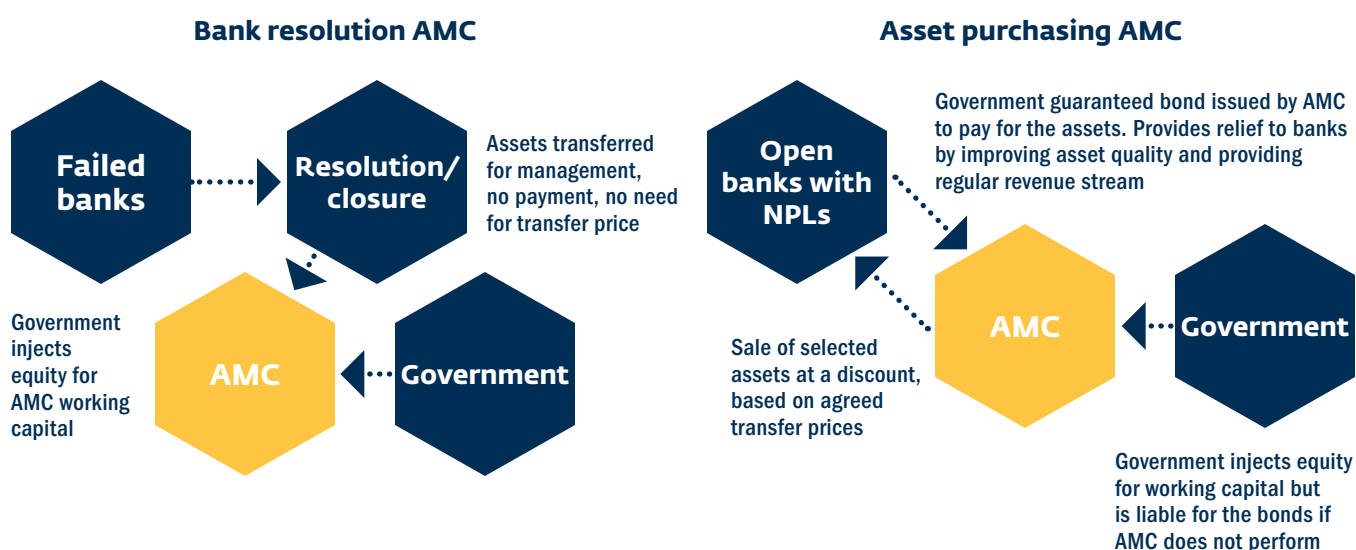
## Public Asset Management Companies: International Experience

This chapter looks at the experiences of public AMCs as a tool to help address financial crises and solve the accompanying high level of non-performing loans. AMCs have a mixed track record. They can lessen the cost of a crisis by managing assets whose value has temporarily declined. However, improper design, political interference, and poor management can erode any benefits, which increases the burden on taxpayers. The decision to create an AMC should not be taken lightly. Experience has shown that successful AMCs are subject to meeting certain preconditions, designed with a commercial focus, and require adequate funding, strong governance, and a high level of transparency. Public AMCs alone cannot solve all NPLs in a

financial system and should be complemented by a comprehensive set of reforms to strengthen bank resolution and supervision, enhance creditor rights and debt enforcement, and facilitate corporate insolvency and restructuring.

## What is an AMC?

An AMC is a corporate entity established to manage and enhance the recoveries of distressed assets removed from the banking system. It can be established either as an entity tasked with resolving failed financial institutions and liquidating their assets (RTC in the United States, Securum in Sweden, the Savings Deposit Insurance Fund [SDIF] in Turkey), or as an entity that purchases assets from open banks (KAMCO in Korea, and recent EU cases in Ireland, Spain, and Slovenia). In the first case, the AMC does not select and purchase the distressed assets. Instead, under the banking law, it is appointed to restructure or liquidate insolvent banks, in whole or in part (usually after the protected deposits have been transferred). Thus, no financial transaction or purchase takes place, and the AMC's assets are remarkably diverse in size and type. In the second case, the AMC purchases assets that meet certain criteria as broadly defined by legislation and/or more specifically



**FIGURE 3.1** Two Types of Public AMCs

Source: Cerruti and Neyens, 4. Note: The asset-purchasing AMC reflects the KAMCO, Danaharta, and EU-model. In the 1990s these AMCs did not issue bonds to the banks; instead the government issued these bonds, as in the case of Eastern European countries and the Indonesian Bank Restructuring Agency (IBRA). In Ireland and Spain AMCs were created as public-private entities to avoid consolidation in the public accounts.

by the AMC itself from banks that are still operating. Usually the AMC issues a government-guaranteed bond to pay for the purchase. In both cases, the value of the assets must be established by a prior assessment or valuation of the assets by the supervisor, or by the AMC through a transparent, market-based due diligence process conducted by an independent third party experienced in valuation. Figure 3.1 illustrates the two types of AMCs.

## Possible Benefits and Drawbacks of a Public AMC

A public AMC, complemented by comprehensive bank resolution and restructuring tools, may provide various benefits:

- **It forces banks to recognize losses and may restore confidence in the financial system by making bank recapitalization needs transparent.** In Ireland, this was the primary reason for the establishment of NAMA. The banking crisis was fueled by a property boom. Neither banks nor developers had the ability to work out the distressed exposures. In late 2008, the government announced a blanket guarantee of all Irish banks' liabilities, then amounting to €440 billion, or twice the country's annual gross domestic product (GDP). But this blanket guarantee was ineffective at decisively addressing capital needs. Applicable accounting rules did not require banks to make forward-looking provisions, and as a result, banks unveiled losses slowly, only when they were effectively incurred. The lack of a clear exit strategy and the uncertainty on bank recapitalization needs weighed heavily on the creditworthiness of the government, which was expected to recapitalize the banks. NAMA was thus created to cap the government's exposure by crystallizing losses on the banks' balance sheets, thereby making recapitalization needs transparent.
- **It improves the asset quality, income, and liquidity of the banks transferring assets.** The use of cash or a coupon-paying, government-guaranteed security to purchase non-earning assets improves asset quality and provides income to open banks. Also, these securities may provide liquidity if they can be used

as collateral for borrowings from the central bank (as is the case of all AMCs in the EU).

- **A centralized AMC manages assets more efficiently.** By gathering a large volume of homogeneous distressed assets, the AMC can package them for sale to outside specialist investors. It has enhanced bargaining power with both purchasers and borrowers, especially when all debtor connections are transferred (case of NAMA). This reduces the fixed cost of asset resolution.
- **It may enable banks to refocus on financial intermediation.** When NPLs reach systemic proportions, banks stop originating credit. By carving out the largest and most complex exposures, the AMC allows banks to refocus on financial intermediation, as long as their credit underwriting practices are significantly strengthened (to prevent more bad loans from being originated).

However, if not designed and managed properly, a public AMC may generate significant losses for taxpayers and undermine credit discipline:

- **Undue political interference may undermine the AMC.** This may happen when the AMC's purchases are politically and not commercially driven and are designed to provide relief to well-connected companies. Robust governance and specific protection against political interference in the underlying law may prevent this.
- **The AMC may engage in "mission creep."** For instance, the law of the Asset Management Corporation of Nigeria (AMCON) allows the purchase of performing loans in strategic sectors, but it is not clear how this purchase helped restore financial stability. Mission creep can be addressed by a narrow mandate in the enabling law and a strict definition of eligible assets.
- **The AMC may weaken credit discipline with successive asset purchases at inflated prices.** Banks may hold on to their assets expecting a better deal from the AMC at the next purchase. During the Asian crisis, borrowers who were in a position to meet their obligations would default ("strategic defaulters") in hopes of being transferred to the AMC where they could repurchase their obligations



at a deeply discounted price. Inflated asset purchases may end up building contingent liabilities for the government that funds the AMC. A thorough valuation process to determine the transfer price and a one-time purchase can mitigate this risk. The Malaysian AMC (Danaharta), NAMA in Ireland, and SAREB in Spain had one-time asset purchases.

- **Failure to dispose of assets in a timely manner, or “warehousing.”** There is an inherent trade-off between warehousing and rapid disposition or “fire sales.” An AMC is created because assets are deemed to have lost value temporarily and that this “impairment” will be recovered as markets improve. Successful AMCs, however, recognize that for this to happen the loans need to be repaired during this holding period either through restructuring in line with the borrower’s capacity to repay and the viability of the business, or the institution of legal proceedings for debt enforcement or liquidation. The more passive approach of just waiting for market recovery leads to further deterioration in the assets and overall lower recovery rates. A good practice consists of fixing a sunset clause in the AMC legislation in line with the nature of the assets (seven years for Danaharta, largely commercial exposures; 15 years for SAREB—real estate exposures) and requiring the AMC in its strategic plan and operations manual to develop specific timebound strategies for the disposal of each category of assets it holds.<sup>32</sup>

## Preconditions and Specific Design Features Required

### Preconditions in the Enabling Environment

**The first precondition is the political will to recognize losses and undertake comprehensive reforms.**

Governments, particularly those in weak fiscal condition, may be unwilling or unable to recognize credit losses that have already occurred but have not been recognized due to weak regulation and supervision. However, the longer it takes to recognize the problem, the larger the losses (Czech Republic and Slovakia in the 1990s delayed the recognition of NPLs, which opened room for substantial asset

stripping, thereby increasing the losses). Political will should extend to a comprehensive package of reforms to address existing weaknesses in bank regulation and supervision and creditor rights, as well as the resolution of impaired assets.

**The second precondition is a systemic crisis and public funds at risk.** A high level of NPLs is not in and of itself a sufficient condition to establish a public AMC. If banks are well capitalized but plagued with high NPLs, they should be required to provide higher provisions, set up dedicated workout units, and draw on external expertise to solve their own problems. To limit the ultimate cost to the taxpayers of resolving financial sector failure, the use of a public AMC should only be considered when financial system weaknesses are systemic.

**A third precondition is a solid diagnostic of the banking system and a critical mass of homogeneous impaired assets.** The diagnostic is necessary to determine the mandate of the AMC, either as a bank resolution entity if many institutions need to exit, or as an asset-purchasing entity in case most of them can continue operating. The diagnostic will identify whether there is a critical mass of homogeneous NPLs that can lend themselves to recovery and the quality of the security attached to these NPLs. The recovery process is costly and best implemented on large and complex loans. To attract professional buyers, assets have to be bundled according to common characteristics (for example, hotels or commercial offices). Thus, the ideal targets for AMCs are large and complex NPLs that can gain in value through the application of specialized expertise and share similar characteristics (real estate backed loans or large industrial loans). For instance, Danaharta removed about 70 percent of the banking sector’s NPLs with only 3,000 loans. The SAREB acquired about 40 percent in value of the REOs held by banks.

**A fourth precondition is a tradition of institutional independence.** An AMC is created within a local institutional framework and culture. As its business is prone to interference, since it often must collect from politically connected parties, it should enjoy strong protection from any third-party influence (the law of NAMA provides for such protection). One

way to protect an AMC is to require transparency of and accountability for its performance in its enabling law. Countries that have a challenging governance environment and weak rule of law are not good candidates for a public AMC.

**A final precondition is a robust legal framework for bank resolution, debt recovery, and creditors' rights.** Many countries that created AMCs launched comprehensive reforms of their bank resolution framework, insolvency, foreclosure laws, and out-of-court restructuring process for firms (for example, Korea, Ireland, Spain, Indonesia, and Turkey). A corporate restructuring process is particularly needed when the assets are loans to large distressed corporates. These reforms not only support the work of the AMC but are also critical for banks to manage the NPLs left on their balance sheets.

**Latvia and Greece show the need to find different solutions when preconditions are not met.** In Latvia, NPLs reached 18 percent of total loans by the end 2010—and 90 percent of residents had loans in foreign currency. But public funds were not at risk: 60 percent of banking sector assets were held by large Scandinavian banks that could be recapitalized by their parent. Banks created specific distressed assets units funded by their parents and took early provisions. In Greece, NPLs reached 45 percent of total loans in the third quarter of 2016. Arrears are scattered across all types of borrowers (that is, non-homogeneous) with the highest concentration in SMEs and small businesses/professionals for which a public AMC has no competitive advantage. However, as few of the preconditions for a successful AMC exist, alternative solutions to a single, national, multi-asset-classes AMC are being explored. These consist of strengthening the insolvency and debt-enforcement frameworks including out-of-court solutions, setting bank specific supervisory targets for NPL reduction, and strengthening credit underwriting practices as well as bank governance to reduce political interference.

### **Commercial Focus, Robust Governance, and Comprehensive NPL Management Strategy**

Experience shows that a strong commercial focus is a key success factor. This requires the AMCs' legal

mandate to emphasize the need to recover assets quickly to avoid fire sales, but prevents warehousing of NPLs and protects the AMC against any political interference.<sup>33</sup> The AMC should employ professional distressed assets management<sup>34</sup> and be required to adhere to good governance practices, robust transparency, and strong internal controls. Strategic and operating plans should be aligned with its mandate as well as the internal and external environment in which it operates. The AMC should also be provided with adequate and timely funding in line with its mandate. To ensure public support and oversight, the AMC should be subject to frequent reporting such as public quarterly reports, bi-monthly reports to legislature, periodic progress evaluations conducted by an external auditor, and public annual audited reports.<sup>35</sup>

**Robust corporate governance practices support a commercial focus.** Legal provisions on the composition, term, appointment, and removal of the board and key management staff should be clearly spelled out in the founding act. Fit and proper criteria, relevant experience, and declarations of interest should be required of board members and key management. The law should also spell out the responsibilities of the board as well as the establishment of key committees such as the audit committee. The Indonesian Bank Restructuring Agency (IBRA) case shows the difficulty of enforcing good governance when the law is silent. Multiple practices have been developed to strengthen good governance. These have included the appointment of international experts on the board (as was done for Danaharta, NAMA, and IBRA to correct initial deficiencies), or as advisers to the board; the adoption and publication of key performance indicators (KPIs) to measure the success of the AMC (such as in Danaharta); and internal staff rules requiring that all communications that attempt to influence staff be reported to the board (in the case of SAREB). AMCs may also benefit from periodic progress evaluations conducted by third parties.

**Public AMCs work best if they are part of a comprehensive NPL management strategy.** Several AMCs (Indonesia, Malaysia, Turkey) were provided with special powers—such as transferring loans in and out of the AMC without borrowers' consent or appointing a special administrator in debtor companies—without

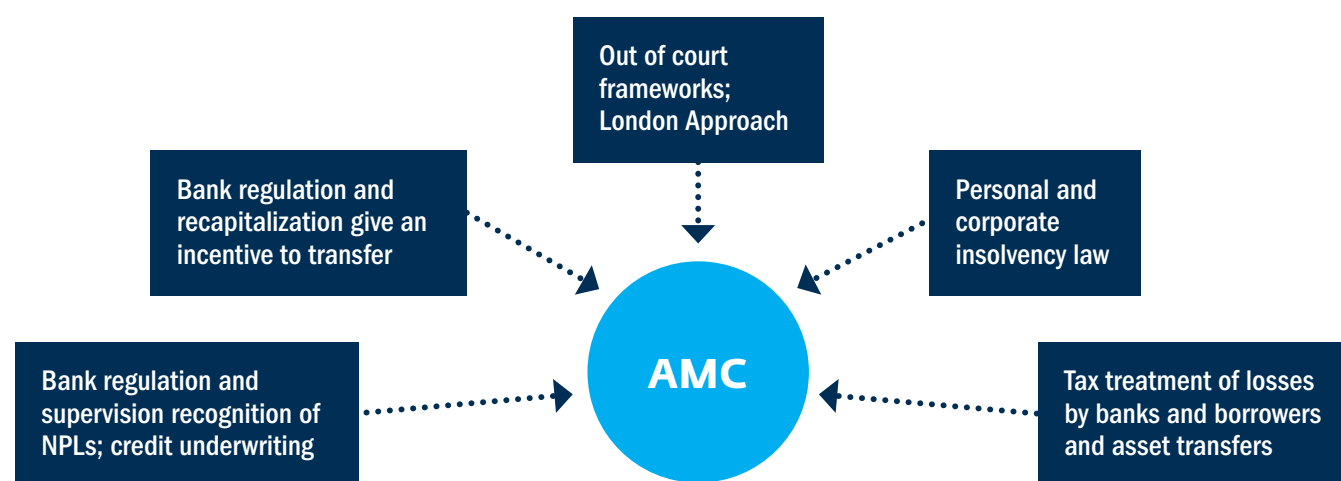
the need for judicial approval to speed up corporate restructuring. However, in the case of IBRA (Indonesia) and SDIF (Turkey), many banks refused to participate in an informal out-of-court corporate restructuring process as they feared that the AMC's powers would place other creditors at a disadvantage. Therefore, the AMC's special powers should be subject to oversight to ensure they are not abused,<sup>36</sup> and should be complemented by a comprehensive NPL management strategy consisting of: (a) tighter bank supervision to recognize and provision early for NPLs, (b) a bank resolution framework to facilitate the exit of failed banks and incentivize the transfer of NPLs to the AMC, (c) out-of-court workout processes to save viable businesses,<sup>37</sup> (d) personal and corporate insolvency reform to rehabilitate viable enterprises and facilitate the liquidation and exit of nonviable ones, and (e) tax reform to allow the restructuring of loans (for instance, by preventing a "gift tax" whereby the borrower may be taxed on the portion of the loan that is forgiven and forgone by the financial institution).

The funding of the AMC should provide time to realize the underlying value of the assets while preventing a permanent warehousing of bad loans. Asset purchasing AMCs need initial capital for working capital and

payment of interest on their bonds; in year two or three of the AMC's life, cash collections should pay for any recovery expenses and financial cost. AMC examples show that initial capital primarily came from the government because the banking sector was very weak. In Ireland and Spain efforts were made to enhance the private sector's "skin in the game." In Ireland, NAMA issued 5 percent of the purchase price of its assets in the form of subordinated debt payable only if performance targets were met. The banks were required by the supervisor to write this debt off. In Spain, SAREB's capital is 55 percent owned by international and local banks and insurance companies.

## EU Guidance and Rules for Transfer Price

The European Commission published an AMC blueprint in March 2018 to provide practical guidance for member states when considering the design and set-up of a public AMC. AMCs should be fully compliant with the EU legal framework including the State Aid Rules, the Bank Recovery and Resolution Directive, and the Single Resolution Mechanism Regulation.<sup>38</sup> The Commission envisions four scenarios of transfer of NPLs from a bank to a publicly supported AMC:



**FIGURE 3.2** Comprehensive NPL Management Strategy

Source: World Bank

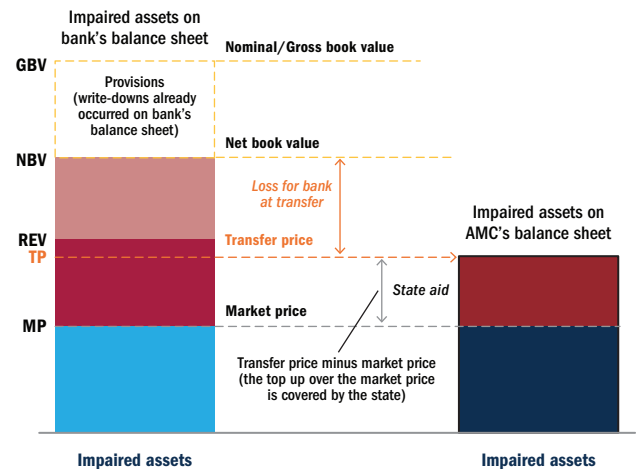
- **Scenario 1: No State Aid.** Publicly supported AMC purchases NPLs from a bank at market value.
- **Scenario 2: Resolution.** In the context of a resolution of a bank, the use of the asset separation tool requires the creation of an AMC to take over selected assets of the bank.
- **Scenario 3: Insolvency Proceedings under National Law.** Separation of the “good” part of an ailing bank for sale from the “impaired” part managed by an AMC, under ordinary insolvency proceedings.
- **Scenario 4: Precautionary Recapitalization.** Exceptional state aid when a bank is not failing or likely to fail but is likely to become distressed if economic conditions were to worsen materially. Transfer of NPLs to an AMC can be associated with a state recapitalization of a bank under certain conditions.

Scenario 4 reflects the cases of Ireland, Spain, and Slovenia where the creation of a public AMC was associated with the public recapitalization of banks which continued to operate (most as state-owned institutions). To comply with state aid rules, the transfer price of assets to the AMC may be above the market price, as long as it is not above the “real economic value,” or REV. The REV is defined as the “underlying long-term economic value of the assets, on

the basis of underlying cash flows and the broader time horizon.”<sup>39</sup> It is intended to be the market price without the illiquidity and credit risk premium required by private investors due to the absence of reliable market prices. Simply put, the discount rate to value the assets using a discounted cash flow (DCF) methodology would be higher in a market price scenario than in a REV scenario.

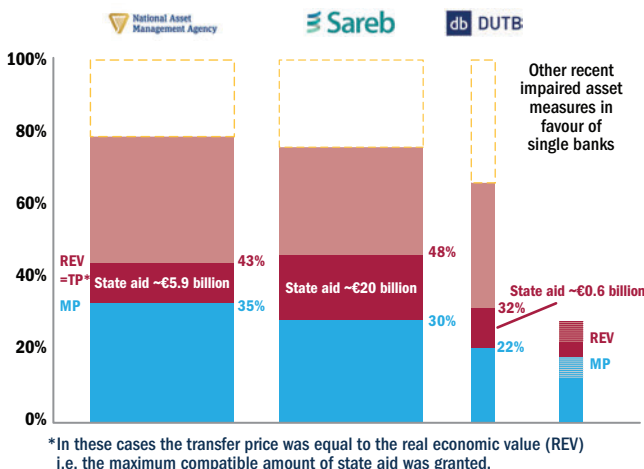
Figures 3.3 and 3.4 illustrate how the amount of state aid is determined and was applied in previous cases. In the case of Ireland, the European Commission granted the maximum amount of state aid since the transfer price was at the estimated REV of €31.1 billion out of a gross asset value of €74.4 billion. The transfer price was 8.3 percent higher than the estimated market price (NB: the difference between 35 and 43 percent on Figure 3.3).

The analysis of asset purchasing AMCs shows a significant discount on the gross value of assets. These range from 52 percent (SAREB) to 68 percent (Bank Asset Management Companies [BAMC/DUTB]) even after applying an uplift factor. This discount does not only depend on the level of distress of the borrower, but also on the strength of creditors’ rights. The main lesson is that the transfer price must result from a thorough process of asset valuation, involving third parties experienced in valuation, a consistent methodology, and public disclosure. The lower the



**FIGURE 3.3** State Aid in the Transfer of Impaired Assets

Source: European Commission



**FIGURE 3.4** Real Economic Value from Previous Cases

Source: Galand, Dutilleux, and Vallyon. “Non-Performing Loans and State Aid Rules.”

purchase price, the easier for an AMC to recover the purchase price and show financial success, but the higher the capital deficiency of the selling institution.

## Examples of Public AMCs

### Early stage: RTC (United States) and Securum (Sweden)

The RTC and Securum represent bank resolution AMCs that received a portfolio of diverse loans from failed banks. They were both very successful at disposing of the assets (at termination they had 3 percent and 2 percent of the initial assets left, respectively) and at recovering on their gross value. The RTC's high recovery rate was in part due to the high-quality assets it received. Only 20 percent of the loans were classified as non-performing and less than 7 percent were in the form of distressed real estate. The RTC's disposal strategies were also supported by the deep and liquid capital markets which allowed it to dispose of a large volume of assets without disrupting real estate prices or relying on individual transactions.

**Securum's success was due to various factors:** (a) homogeneous portfolios being transferred (large corporates with commercial real estate including the Nobel industries); (b) a strong tradition of rule of law which allowed the restructuring of state-owned companies without political interference, and an efficient insolvency framework so that Securum did not require any special powers (70 percent of the companies with loans in Securum were forced into bankruptcy); and (c) a rapid economic recovery following the banking crisis, which helped the corporate sector to get back on its feet.

### Asian and Turkish Crisis: KAMCO (Korea), Danaharta (Malaysia), IBRA (Indonesia), SDIF (Turkey)

KAMCO is an example of AMC purchasing from a wide variety of financial institutions. It purchased over 300,000 NPLs from commercial and merchant banks, investment trust companies, and securities companies, which was explained by the severity of the crisis in a corporate sector exposed to multiple financial institutions. One percent of borrowers accounted for

90 percent of the face value of NPLs, illustrating the *chaebol* economy.<sup>40</sup> KAMCO is credited with creating a distressed debt market, but its recovery efforts were overshadowed by high operating expenses that averaged 30 percent of collections.

**Danaharta was a successful asset-purchasing AMC with a clear mandate and strong governance.** It was part of a comprehensive framework to recapitalize viable banks, merge them, and support voluntary corporate workouts. It carved out 70 percent of banks NPLs with only 3,000 loans. It also benefitted from an economic recovery that helped borrowers to stay afloat. Danaharta adopted a strong system of corporate governance with quarterly reports, publication of KPIs, collegial decisions in committees, and professional staff remunerated on the benchmark of local banks.

**IBRA epitomizes the lack of preconditions, poor governance, and a too-large mandate that undermined the AMC's performance.** None of the preconditions for effective AMCs (political consensus, strong bank resolution and corporate insolvency framework, credit culture, institutional independence) existed in Indonesia. IBRA was tasked with resolving banks, recovering the misused liquidity support, supporting corporate restructuring, and managing distressed assets. As a result, it only focused on asset management in the last two years of its life when it realized 87 percent of its sales. IBRA was intended to represent a new approach in the spirit of *reformasi*,<sup>41</sup> but a lack of transparency coupled with political interference in many of the loan restructurings harmed IBRA's credibility in its early years. In the end it only recovered 22 percent of the face value of NPLs transferred.

**The SDIF shows that asset management can be performed by an existing institution.** The SDIF is the deposit insurance fund that was given the mandate to resolve failed banks and manage their assets in 1999. The use of an existing agency avoided a prolonged start-up period. However, the SDIF's bank restructuring mandate forced it to focus on resolving the banks as quickly as possible—and asset management activities only started four years after the crisis began. A special power to collect former bank owners' NPLs—most of which related to the misuse of liquidity support in the early stages of the crisis—as state receivables (no discount coupled with the ability



to seize assets not serving as collateral) allowed SDIF to realize 72 percent of its collections from these loans.

### Latest Examples: NAMA (Ireland), AMCON (Nigeria), SAREB (Spain) and BAMC (Slovenia)

All these AMCs arising from the 2008 global financial crisis were set up as asset-purchasing entities. They purchased assets from open banks at a predetermined price through the issuance of government-guaranteed bonds. The EU AMCs share common features with asset transfer at real economic value, and recapitalization of the banks following state aid rules. But they faced different challenges.

- **Seven years after starting operations, NAMA redeemed its senior debt in October 2017 ahead of schedule.** It benefitted from strong political consensus and its founding law enshrined independence, accountability, and a strong commercial focus. NAMA was also helped by a concentrated portfolio (19 percent of debtors in number represented 78 percent of the nominal debt acquired), a sizable portfolio in the United Kingdom that generated 80 percent of sales in the first two years, and a consolidation of all debtor connections so that 20 percent of all loans acquired were performing and generated income in early years. The share of NPLs remained high within the banking sector after NAMA's intervention (culminating at 27 percent of total loans in 2013), and therefore personal insolvency reforms and supervisory guidance on NPL reduction on a bank-by-bank basis has complemented NAMA's efforts.
- **SAREB came into existence as a last resort tool under an EU and IMF program designed to restore financial stability.** It took on its balance sheet about 200,000 assets, a much higher number than NAMA or Danaharta. The same banks that transferred assets were servicing them at inception, which was fraught with conflicts of interest. Thus, SAREB launched a competitive process in 2014 to consolidate its servicing agreements with professional companies. As of the end of 2017, SAREB had redeemed 25 percent of its government guaranteed debt, but reported losses due to financial and operating costs in each of its fiscal years. Specific accounting treatment from the Bank of Spain was required to address the

revaluation of assets after they were assumed by SAREB and allowed SAREB to remain solvent.

- **Issues of independence have been raised in the case of BAMC after several senior management resignations.** In late 2015 amendments were made to the BAMC law clarifying that (a) BAMC is operationally independent, as the Ministry of Finance (representing the state) may not issue instructions to BAMC for action on individual cases, (b) responsibility for management of BAMC rests with its executive directors, and (c) BAMC has broad powers to restructure companies in its portfolio. BAMC received a more challenging asset mix compared to NAMA or SAREB, mainly large conglomerate loans in various sectors.
- **Though set up as a purchasing asset management company, AMCON also had to absorb the negative equity of eight failed banks.** It is thus carrying a significant negative equity on its books, one which has no prospect of recovery. The definition of eligible assets in its founding law was broad and allowed AMCON to purchase strategically important assets that were not NPLs. AMCON also purchased unsecured loans and loans backed by shares (margin loans) in 2010–11, which do not require active asset management. Successive asset purchases raise the question of the adequacy of the transfer price. Information on the transfer price is not available; nor are online audited financials. Finally, the significant powers of the Central Bank over AMCON as the mandate setter, regulator, and creditor (it is the only institution holding AMCON bonds) create conflicts of interest with the mandate of supervisor. Overall AMCON's experience gives the impression that it was created with the intention of hiding losses arising from the resolution of banks rather than to protect the taxpayer.

In conclusion, AMCs are not a silver bullet for a high level of NPLs. They can help in the context of a comprehensive NPL resolution strategy if certain preconditions are met to ensure they do not represent an undue burden on the taxpayers, and if they are not used as a tool to hide losses. When preconditions are met, experience shows that a commercial focus and robust governance practices are critical success factors. Table 3.1 on the next page summarizes key data on AMCs. ■

### BOX 3.1 AMCs of Vietnam and China

**China.** A critical element of the recapitalization of the banking sector in the late 1990s and early 2000s was the creation of the big four asset management companies. They were initially charged with the task of acquiring NPLs from the four major state-owned banks and progressively restructuring them. They had no lifespan and no disclosed acquisition price. These companies have now diversified into financial conglomerates.

- **China Huarong** was established in 1999 for the acquisition and settlement of NPLs of Industrial and Commercial Bank of China (ICBC). It resolved NPLs in various ways, including NPL pooling, asset backed securities, debt-equity swaps, and JV-AMC establishment. It later became a limited company in 2007 and continued to pursue listing on the stock market. China Huarong raised HK\$17.8 billion through an initial public offering (IPO), offering 5.77 billion new shares in Hong Kong SAR, China, in 2015.
- **China Cinda** was established in 1999 to resolve NPLs of China Construction Bank Corporation (CCBC). Initially it was a major task to acquire and clean up the NPLs of CCBC through the issuance of government-guaranteed bonds, but since the late 2000s, it expanded its business scope to buy bad loans from other commercial banks as well as to dispose of large-scale bad assets of non-financial institutions. Since then, it has been the first among AMCs in China to implement \$2.5 billion in IPO on the Hong Kong Stock Exchange in 2013 and has undertaken a transition to a comprehensive financial holding company through the establishment of insurance and securities subsidiaries.
- **China Great Wall** was founded in 1999 for the resolution of NPLs of Agricultural Bank of China. Since the late 2000s, the scope of business was

expanded to include corporate restructuring and investment advisory service. Currently, China Great Wall offers acquires, manages, and disposes NPLs in state-owned commercial banks. It also provides debt collection, asset exchange and leasing, asset assignment and sale, debt restructure and enterprises reorganization, debt-equity swap, and asset securitization services.

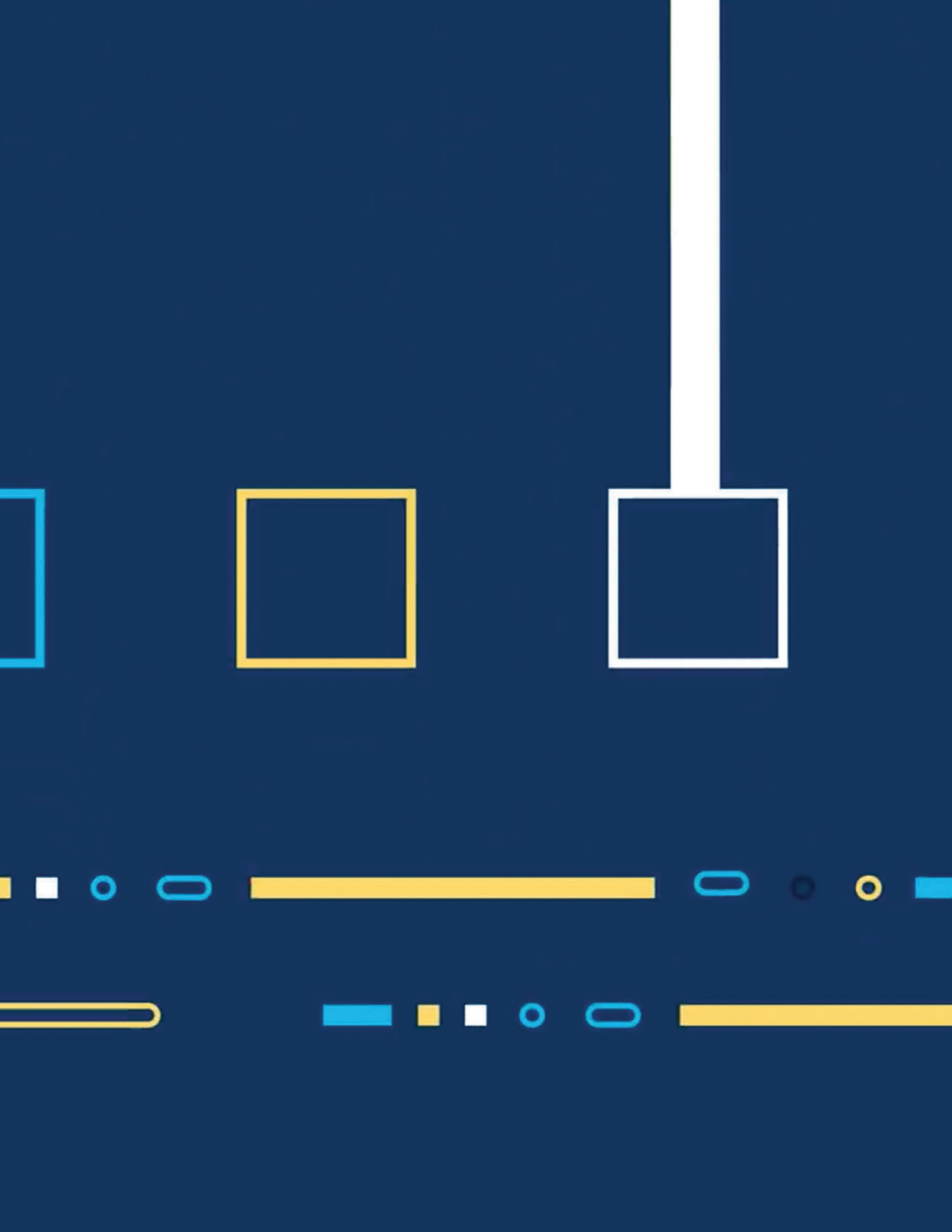
- **China Orient** was founded in 1999 for the Bank of China. It runs two major business units since 2006, one for general commercial activities and another for the management of the shares that converted from NPLs, which was classified as assets under management. In 2015 the group expanded as a full-service financial conglomerate by acquiring the Bank of Dalian. In 2016 the corporation was re-incorporated as a company limited by shares, China Orient Asset Management Co., Ltd from China Orient AMC.

**Vietnam.** Central Bank of Vietnam established the Vietnam AMC (VAMC) with an initial capital of 2 trillion Vietnamese dong in 2013 with the goal to purchase and clean up bank bad loans of a total cumulative value of D 330 trillion by 2020 to stabilize the banking system. As of 2017, VAMC acquired non-performing loans of D 301 trillion from a total of 42 financial institutions, of which D 60 trillion were recovered. VAMC's purchase of NPLs has had the effect of lowering banks' nominal NPL ratios, but it still shows operational limitations, with unresolved NPLs reaching 80 percent. In response, the Vietnamese government is seeking to revitalize the VAMC's handling of NPLs by preparing a special parliamentary resolution that calls for the rapid disposal of NPLs.

*Source: Forthcoming World Bank Policy Note on Centralized Asset Management Companies in Asia.*

**TABLE 3.1** Examples of Public AMCs

	<b>Mandate</b>	<b>Special powers</b>	<b>Lifespan</b>	<b>Asset transfer price</b>	<b>Eligible loans</b>	<b>Recovery from face value</b>
<b>RTC</b> (U.S.) 1989	Resolve thrifts (banks)	None	7 years	Did not purchase	n.a.	87% (on assets only)
<b>Securum</b> (Sweden) 1993	Restructure NPLs of state-owned Nordenbanken, later expanded to include Gota bank	None	10–15 years envisioned, reduced to 5 years	Did not purchase	n.a.	n.a.
<b>KAMCO</b> (Korea) 1997	Asset management	None	None specified	Internal pricing based on DCF Discount = 64%	Priority to sizeable NPLs & with multiple creditors	46.8%
<b>IBRA</b> (Indonesia) 1998	Resolve banks, administer deposit guarantee, recover misused liquidity support	Yes	6 years	Did not purchase	n.a.	22% (on NPLs)
<b>Danaharta</b> (Malaysia) 1998	Asset management Receiver for 2 banks	Yes	7 years	Appraisals Discount = 54%	Large and industrial loans	58%
<b>SDIF</b> (Turkey) 1999	Resolve banks, administer deposit guarantee, recover misused liquidity support	Yes	None specified	Did not purchase	n.a.	16% (NPL sales only)
<b>NAMA</b> (Ireland) 2008	Asset management	Yes (but not used)	Expected to close in 2020, but ahead of schedule	Appraisals. REV uplift of 8.3% Discount from Book Value = 57%	Large real estate loans	54% (as of June 2017)
<b>AMCON</b> (Nigeria) 2010	Asset management; recapitalize failed banks; invest in equities	Yes	None specified	Guidelines from Central Bank Discount = 54%	Any loan reasonably expected to become substandard	n.a.
<b>SAREB</b> (Spain) 2012	Asset management	None	15 years	BoS & independent valuation. REV with uplift ~18% Discount = 52.4%	Large real estate loans	19% (as of June 2017)
<b>BAMC</b> (Slovenia) 2013	Asset management	None	10 years (until 2022)	Independent valuation REV with uplift ~10% Discount = 68%	Large loans multi-sector	23% (as of June 2017)



## CHAPTER 4

# Attractive Markets for Investing in Distressed Assets

By Josep M. Julià, Eric D. Cruikshank, and Marta Sánchez Saché

Non-performing loans are found in virtually every country. However, the prospect of them being resolved effectively through wholesale approaches depends on certain preconditions. When investors consider entering a new market, they ascertain and analyze a number of these preconditions, the key ones being the market size, the macroeconomic environment, the legal and regulatory framework, the quality of information, as well as the servicing capacity and the investor base. In this chapter, we will briefly examine these five crucial elements.<sup>42</sup>

### Market Size

The size of the NPL pool in terms of potential recoverable value is clearly important in attracting institutions with knowledge of and expertise in distressed assets resolution. Some of these will be entities that have established track records in designing and implementing a variety of recovery strategies (settlements, enforcement, OCWs, judicial reorganizations, or liquidations). Others will be institutional investors that have the mandate and familiarity with distressed assets as an investment class to allow them to participate as investors in NPL transactions. Most of the distressed assets investors look for a minimum potential market size to justify the effort and associated costs of entering a new market. However, while the face value of loans outstanding is the starting point in ascertaining the size of the NPL pool, other preconditions will be crucial in determining the likely recoverable value of those assets and the actual potential investment opportunity. This chapter focuses on the size of the opportunity specific to NPLs. As such, the opportunities for investors in distressed assets markets are much larger when also considering special situations and special lending opportunities.

### Macroeconomic Environment

The macroeconomic environment of any given economy is critical to attracting investors to the distressed assets space. Investors will consider the economic growth outlook and current and expected macroeconomic policies (fiscal and monetary) in the country, as well as other global forces and any political challenges within the investment horizon that may affect the macroeconomic outlook. For example, an incipient economic recovery could offer better prospects for returns on investments, as distressed assets can be priced conservatively, with increased room for upside.

Although financial crises often generate distressed assets in quantities sufficient to stimulate the development or expansion of a distressed assets market, the private sector players that are key to NPL resolution initiatives are unlikely to become fully engaged<sup>43</sup> until they see signs that a financial crisis has bottomed and that asset values are no longer in free fall—investors understandably want to avoid trying to “catch a falling knife.”

### Legal and Regulatory Framework

Effective NPL resolution depends on having the support of a well-designed legal and regulatory framework in place. Such a framework should address: (a) the enabling environment, as discussed in Chapter 2, (b) macroprudential regulation, (c) supervisory guidance and action, and (d) direct intervention. A framework that can accommodate strong private sector participation in the resolution of distressed assets requires, first and foremost, a government stance in favor of such an approach. Governments committed to effective debt enforcement will at least lay the groundwork for: (a) improving predictability and transparency, (b) facilitating the reduction of NPLs, (c) encouraging new business relationships, (d) enabling rapid real-asset redeployment, and (e) promoting



financial sector stability. Similarly, investors will place a significant weight on regulatory frameworks when assessing the actual recoverable amount and, as a result, the potential market size.

Table 4.1 presents the main layers of a legal and regulatory framework. At the broadest level—shaping the enabling environment—is the framework that regulates financial institutions and the relevant tax regime. Also, at this level is the framework directly relevant to corporate debt recovery and asset resolution, which includes the insolvency regime, collateral debt enforcement framework, and provisions for out-of-court restructuring. The next level pertains to macroprudential regulation, which effectively limits the different types of risks associated with lending activities. These range from regulatory ceilings imposed on loan-to-value ratios, debt-to-income ratios, loan growth, net foreign-exchange exposure, and reserve requirements. Supervisory guidance at the following level of the overall framework deals with measuring and reporting asset quality in accordance with an established loan-classification system as well as how NPL income is recognized and problem loans are either provisioned or written off. The final and most direct level (from the perspective of public sector involvement) includes *ad hoc* and systemic conditions that trigger bank interventions, mandated asset-resolution approaches, and the formation of public AMCs, as covered in Chapter 3.

## Quality of Information

Accounting standards—in terms of the country’s adoption of international best practices as well as enforcement—are essential for early identification of problematic (and potentially problematic) assets on the balance sheets of banks, other lending institutions, and credit originators. Lending institutions must also have clear and comparable systems for loan classification in place, along with consistent and binding rules for classifying loans. Clear and well-enforced rules for loan-loss provisioning are also essential. Collection and reporting of this information will usually be enforced by the concerned regulatory agencies—the public sector entity responsible for bank supervision and the entity responsible for overseeing non-bank financial institutions (NBFIs).

In addition, there is often a lack of publicly available information on important value drivers, such as value of properties or employment status of debtors, that may limit the analysis of the assets to be acquired, negatively impacting their pricing. Therefore, when there are material deficiencies in timely and reliable loan information—or when such information is not made available to potential investors—then the perceived recoverable value will be much lower than, for example, a stock of similar face-value loans in a country where information is generated earlier and is of better overall quality.<sup>44</sup>

**TABLE 4.1** Legal and Regulatory Framework

Enabling Environment	Macroprudential Regulation	Supervisory Guidance & Action	Direct Intervention
Prudential regulation	Loan-to-value ceilings	Asset quality reviews	Bank interventions
Sound bank supervision	Debt-to-income ceilings	Supervisory guidance on:	Mandated strategies
Insolvency regimes	Limits to lending growth	• Provisions	Public AMCs
Collateral enforcement	FX lending limits	• NPL income	
Tax regime	Reserve requirements	• Recognition	
Out-of-court settlement framework	Macroprudential supervisory review tools	• Collateral valuation	
	Counter-cyclical buffers	• Write-offs	

Source: Karlis Bauze, “A Holistic Approach to NPL Resolution.” Presentation to the FinSAC NPL Conference, May 15–16, 2018, Vienna, Austria.

## Servicing Capacity and Investors Base

Two factors play a significant role in facilitating NPL sales. First, servicers hold information that is valuable to investors for pricing purposes and have the expertise and necessary local knowledge to manage NPLs. At the time of underwriting new NPL portfolios, availability of prior data on historical collections is a critical component for interested investors to accurately price these assets. Once NPLs have been acquired, an appropriate servicing infrastructure is required for investors to manage the underlying assets and monetize estimated recoveries. Therefore, the wider the installed servicing infrastructure, the easier it is for investors to consider transactions in that market.

Second, the level of competition is, as in any other industry, a key consideration when assessing the attractiveness of a distressed assets market. As the preconditions described above evolve in the right direction, investors feel more comfortable in deploying capital and, over time, the nature of these investors changes. In the initial stages of the development of a distressed assets market, when some of the needed preconditions emerge, only a handful of investors will consider venturing into that market. These are usually specialized investors that are willing to take a higher level of risk in exchange for higher returns. As the market matures, the competition increases, and over time these specialized investors are joined or replaced by institutional and strategic investors in search of more stable and developed distressed assets markets and that usually have lower return requirements.

## Future IFC Focus—Attractive Markets for Distressed Assets Resolution

With more than a decade of experience in investing in NPLs globally through DARP, IFC has identified six countries that have met—or are working to put in place—the preconditions for large-scale distressed-asset resolution, thus warranting priority focus. These countries—Brazil, China, Greece, India, Turkey, and Ukraine—are briefly reviewed below in terms of these market preconditions.

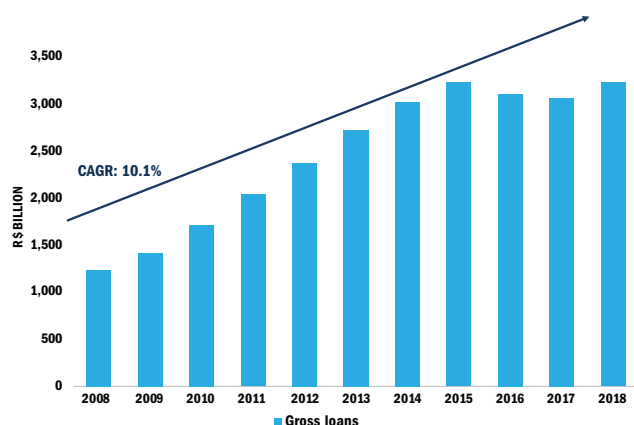
## Brazil

### Market Size

Over the past two decades, banking penetration in Brazil has increased significantly, accompanied by a corresponding increase in the total stock of NPLs. In addition, it is expected that NPL volumes will continue increasing both organically with credit expansion, as well as being further fueled by Brazil's economic recession of the past few years.

The NPL market in Brazil is characterized by a large critical mass. The volume of E–H<sup>45</sup> rated credits, which stands at 6.4 percent of total loans, grew at a compound annual growth rate (CAGR) of 12.4 percent from 2008 to 2018, from R\$65.3 billion (equivalent to approximately \$27.8 billion) to R\$210.8 billion (equivalent to approximately \$54.3 billion)—a figure that becomes much larger when considering off-balance-sheet exposures. This growth pattern exceeds the comparable growth rate of 10.1 percent for the total volume of loans over the same time period.

In parallel with the increase in the NPL volume, the distressed assets market has been growing and evolving in Brazil. In its initial stages, only a limited number of banks would sell NPL portfolios on a regular basis. At first, they sold small portfolios and, as the market evolved, these banks increased the size of the portfolios as well as the range of asset classes available for disposal. Eventually, other large banks, including state-owned banks and non-financial institutions, began selling loans. Subsequently, as has also been the case in many other markets, banks began to explore more strategic solutions to develop efficient tools to manage their increasing stock of NPLs. In addition, with the introduction of IFRS 9 (an international financial report standard that addresses the accounting for financial instruments), it is expected that large-scale sales will be more likely, as financial institutions will have less room to rely on restructurings to manage their NPLs, increasing pressure to dispose of them. However, given that the largest banks in Brazil have recently acquired servicing companies specialized on the retail space, they may offload some of their retail NPLs to their own servicers and not necessarily make them available to the market.



**FIGURE 4.1** Brazil—Total Loans

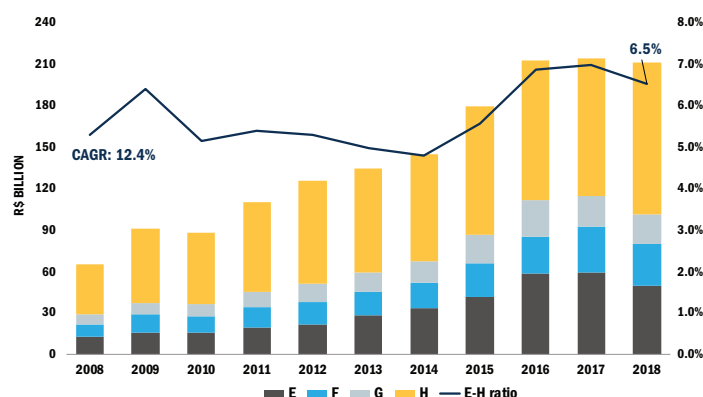
Source: Brazilian Central Bank.

Given that these acquisitions are still recent, involving an inevitable transition period, it is too early to tell what the final impact in the evolution of the distressed assets market will be.

In the past few years, other asset classes have emerged and are becoming more relevant in the distressed assets space, notably, real estate owned assets, legal claims, and *precatórios*. REOs are collateral already foreclosed by banks, which banks are increasingly willing to dispose of. The estimated volume of REOs is R\$26.7 billion (equivalent to approximately \$6.9 billion). *Precatórios* are payment orders issued by the judiciary to the executive branch or its agencies due to a final and unappealable decision. *Precatórios* can be federal, state or municipal. The uncertainty regarding *precatórios* is about the timing of the payment, while the uncertainty regarding legal claims, in addition to the timing of the payment, is about the decision of the judge (that is, the merit of the claim and/or the amount under dispute). According to market estimates, the volume of legal claims and *precatórios* is approximately R\$300 billion (equivalent to approximately \$77.3 billion).

### Macroeconomic Outlook

Brazil is expected to post its third year of weak growth in 2019 following a deep recession in 2015–16, during which the economy contracted by 8 percent in real terms. GDP per capita is not expected to return to



**FIGURE 4.2** Brazil—E-H Rated Loans

Source: Brazilian Central Bank.

pre-recession levels before 2024. A combination of heavy debt throughout the economy, deteriorating public finances, and structurally weak productivity growth are hindering growth. Political uncertainty also contributes to the challenging outlook.

The World Bank cut its 2019 GDP growth forecast to 1.5 percent (from 2.2 percent in its January 2019 forecast). Public finances are the greatest immediate threat to economic stability. The IMF forecasts a budget deficit of 7.3 percent of GDP this year (up from 6.8 percent of GDP in 2018), and projects public debt to reach 90 percent of GDP, up from 88 percent of GDP in 2018. The government has submitted social security reforms to Congress, a key step toward stabilizing public finances. Its proposal would lower the system's annual deficit of 6 percent of GDP.

The government also plans major asset sales, privatizations, and budget cuts. It aims to raise Brazil's long-term growth rate through ambitious productivity-enhancing reforms liberalizing trade, deregulating domestic markets, and reforming tax and labor laws. Other key economic indicators are relatively sound but consistent with weak growth.

Other key economic indicators are relatively sound, consistent with weak growth. Inflation is within the Central Bank's central target of 4.25 percent ( $\pm 1.5$  percentage points.) The current account deficit is forecast at 1.7 percent of GDP in 2019. It is not

expected to widen significantly and is easily covered by expected FDI inflows of \$84 billion. The currency depreciated by 1.7 percent in the year through May 31 after weakening 14.6 percent in 2018.

### Legal and Regulatory Framework

Brazilian legislators promulgated the existing bankruptcy law, *Nova Lei de Falências e Recuperação de Empresas*, on February 9, 2005, replacing a 1945 law. This improved the outlook for companies seeking bankruptcy protection in several ways, primarily by introducing to Brazil (presumably inspired by U.S. Chapter 11) the concept of an organized court-supervised restructuring process.

Prior to the 2005 law, Brazil's bankruptcy system (the *concordata*) offered little recourse to creditors other than stretching out payments over longer maturities and at higher interest rates, rather than restructuring the debt or the business. Troubled firms, therefore, were invariably destined to fail as secured creditors foreclosed on their collateral to recoup what little they could. The 2005 law with its specialized restructuring process—*Recuperação Judicial* (translated as “judicial recovery”)—provides an incentive to creditors to play an active role in preserving a troubled firm's value rather than bleeding it dry.

Although the 2005 law represents a positive development for asset resolution in Brazil, legal specialists nonetheless flag a few caveats regarding ways the Brazilian insolvency system is inconsistent with good practices:

- Controlling shareholders can exert greater influence over the judicial restructuring process than can their counterparts in the United States. They can present a plan, veto adjustments, or unilaterally choose a buyer for their assets—in contrast to the rights of secured and unsecured creditors that have less latitude for action and a relatively less-influential role in the process.
- Bankruptcy courts have widely-varying familiarity with bankruptcy law from state to state within Brazil. The result is that legal outcomes can vary extensively and lack consistency. Compounding this, the law requires troubled companies to file their petition for bankruptcy in the state in which their headquarters is domiciled—unlike in the United States.
- Despite the appearance of a tight timeline for key milestones in the judicial restructuring process, the entire process can involve lengthy delays.
- Whereas the failure of key stakeholders to reach an agreement should trigger court-ordered liquidation as a subsequent step, the judicial administrator, who is appointed by and who reports to the bankruptcy judge, often will provide the judge with grounds for avoiding liquidation.
- There are practical aspects in the application of the law that leave creditors unprotected, often due to judicial “creations.” Some of these aspects entail “substantive consolidation” of assets in cases of groups of companies and the exclusion of certain creditors from voting the reorganization plan because they have been deemed “abusive,” very often for arbitrary reasons.

With acquired knowledge of the judicial process and the help of specialized advisors, creditors do have several ways of improving their recovery rates within this framework. In part, this hinges on them understanding which parts of the process are negotiable and which are not. Creditor prospects can also be enhanced by their careful recourse to providing well-structured DIP financing. Currently, this law is being amended to address issues identified by market participants, based on over 10 years of experience since its enactment.

### Quality of Information

In Brazil, accounting standards are strong, bank asset classification is reliable and financial information collection and reporting systems are well developed. In addition, the amount of information being made available by sellers to prospective buyers is generally sufficient and of a quality that allows investors to properly assess the value of the NPLs being offered for sale.

### Servicing Capacity and Investor Base

While the servicing infrastructure in Brazil has evolved significantly over the last decade, it is currently in the midst of a major shakeup that could change the layout of the industry. A decade ago, the Brazilian NPL market was emerging with very limited servicing

capacity that mainly consisted of collection agencies providing third-party servicing to banks. Gradually, as the market developed, some master servicers that specialized in the retail NPL space were established, and they focused on partnering with investors to underwrite and manage NPL portfolios. As such, only a few sophisticated servicers currently operate in the country, mainly focused on retail NPLs, while the servicing capacity for corporate NPLs remains scarce.

Over the last three years, a change in the servicing industry has occurred. The largest banks in Brazil have been acquiring these independent retail NPL servicers to build their own captive resolution infrastructure with a dual objective of: (a) improving the collections of their own NPL portfolios, and (b) acquiring NPL portfolios of other financial institutions and credit originators to invest in an asset class with an attractive return. This new environment poses the following questions: where is the Brazilian NPL market heading? Will it become a captive market where each bank ends up resolving its own NPLs or will bank-owned servicers continue buying NPLs from third parties? As the stock of REOs continues to grow on their balance sheets, will Brazilian banks follow the trend of some of their European counterparts and spin off and sell their REO management units?

Brazil's distressed assets market is a moderately competitive one. After a few years during which international investors had an active presence in the market, domestic investors dominate. Lately, several foreign investors have been exploring the market, with only a few currently active. Given its potential size, the Brazilian distressed assets market can easily accommodate additional domestic and international investors.

### Going Forward

Provided that the incipient economic recovery does not derail, Brazil justifiably appears to qualify as an attractive distressed assets market. In addition to banks selling NPL portfolios, more non-financial institutions are expected to join them. Also, new asset classes are expected to be traded in scale, including mortgages and REOs, for which the market, so far, has only seen a handful of trades.

### BOX 4.1 DARP Involvement in Brazil

DARP has played a critical role in the development of the distressed assets market in Brazil through its programmatic approach, complementing the efforts of the World Bank Group's FCI GP to help improve the country's insolvency regime and creditors' rights. In 2010, IFC made an equity investment in a local specialized servicer, Recovery do Brasil Consultoria (Recovery), which over time became one of the leading servicers in the country. The second step in this strategy was ensuring that this servicing platform had the appropriate funding to acquire NPL portfolios across financial institutions and react quickly as opportunities arose. For this purpose, in 2012, IFC established a DARP platform in partnership with Banco BTG Pactual. In March 2016, Itau Unibanco, the largest Brazilian privately-owned bank, acquired a controlling stake in Recovery as well as in this DARP platform, and became IFC's partner for distressed assets investing in Brazil. This platform is one of the leading platforms in the country through which IFC has made a material development impact, as it: (a) has allowed Brazilian banks to offload R\$45 billion (equivalent to approximately \$20 billion) in face value NPLs, while (b) is helping normalize the debt obligations of over 15 million households and SMEs. This platform has acquired NPL portfolios from several of the largest financial institutions, including Banco Santander (Brasil) and Bradesco.

## China

### Market Size

From 2010 to 2018, Chinese bank NPLs have grown at a CAGR of 24.6 percent, from Y434 billion (equivalent to approximately \$66 billion) to Y2,025 billion (equivalent to approximately \$294 billion), while gross loans have grown at a CAGR of 16.3 percent. Since the mid-2000s until 2015, NPLs remained below 1 percent, reflecting the fact that many problem loans were not captured in the published data. The current NPL ratio of 1.8 percent, which banks have been able to effectively stabilize during 2018 due to the elevated level of write-offs, reflects a combination of adverse



economic conditions causing borrower distress as well as improved loan classification and reporting. In this context, since 2017, the China Banking and Insurance Regulatory Commission (CBIRC) has requested that banks ensure that lending classified as investments is reflected in their balance sheets properly. This process has forced banks to recognize a higher NPL ratio. It is also worth mentioning special mention loans (SMLs), which are loans that have been classified as of being better quality than NPLs but with signs of potential problems. The SML ratio stood at 3.3 percent of the total loan portfolio, amounting to Y3.4 trillion (equivalent to approximately \$494 billion). In June 2018, regulators improved bad-loan recognition by abolishing the “overdue but not impaired” category for loans overdue more than 90 days, with these exposures now being treated as NPLs rather than as SMLs. In addition, according to market estimates, there are another Y4.3 trillion (equivalent to approximately \$625 billion) of NPLs on the books of public sector AMCs. The banks’ volume of NPLs and SMLs combined with these AMCs’ stock of distressed assets amounts to approximately \$1.4 trillion, representing a high volume of loans that these institutions may want to dispose of.

As described in Chapter 3, for the most part, NPL resolution has been concentrated in the hands of these public sector AMCs that were formed with the approval of China’s banking regulator: first, in the 1990s when the four large national AMCs were established, followed later in 2013 when the government allowed the creation of a limited number of licensed AMCs in each province. In fact, banks cannot sell portfolios of NPLs directly to investors and must use the AMCs, unless they are selling portfolios of three assets or less. Since 2013, 61 provincial AMCs have been established. Initially, they had to resolve the acquired NPLs internally, but after 2016, they can also on-sell them to third-party investors. In addition, new regulations governing provincial AMCs are expected to be introduced, which are likely to further level the playing field between national and provincial AMCs. One of the key changes will be lifting restrictions for provincial AMCs to participate in NPL portfolio sales that are auctioned by nationwide banks in other regions.

As the market continues to develop, new channels for

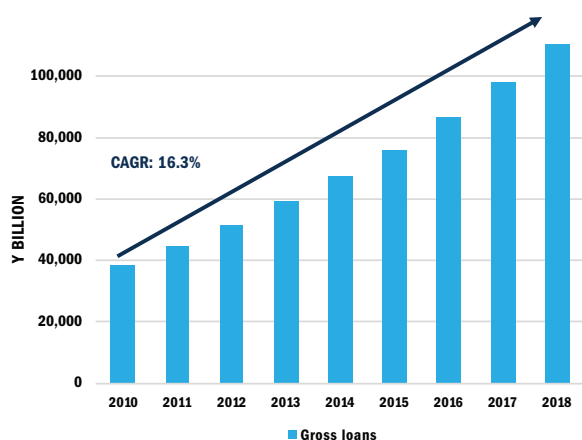
the disposition and acquisition of distressed assets, in addition to the AMCs, are being established, such as:

- **Securitization:** This is the only route for investors to tap into the consumer NPL market, as banks cannot sell this type of NPLs.
- **Over-the-counter sales:** A number of financial exchanges across China allow the exchange of NPLs.
- **Debt-to-equity swaps:** Debt-to-equity swaps are becoming an increasing avenue for resolution of NPLs, following the establishment of Asset Investment Companies (AICs). These are subsidiaries of the largest commercial banks established to focus on debt-to-equity swaps related to their large or strategic non-performing assets.

NPL prices rose aggressively throughout 2017, such that AMCs that at the end of 2016 typically sold NPL portfolios for about 30 percent of their face value were able to realize as much as 80 to 90 percent in some parts of the country a year later, when inflated prices accompanied by a spike in real estate prices drove transaction prices upward. Over the last few months, NPL prices seem to have slightly moderated, although they are still at relatively high levels.

## Macroeconomic Outlook

After more than three decades of unprecedented economic growth and poverty reduction, structural problems have reduced China’s previously strong GDP double-digit growth rates to a still-strong 2017 annual growth rate of 6.9 percent. Economic activity remained resilient in the first half of 2018 with GDP growing by 6.8 percent year-on-year but declined in the latter half to end the year at 6.6 percent, its lowest level since 2009. This has transpired while the country reorients itself from being predominantly export-focused to developing its internal markets and rebalances itself to accommodate stronger consumption and services-led growth. Yet some signs of fragility persist (including financial leverage in the non-financial sector and ongoing trade tensions) with GDP growth forecasted to decline further to 6.2 percent over 2019–20 (World Bank). The country’s economic prospects, nonetheless, remain positive over the medium term, provided the economy continues to move up the value chain



**FIGURE 4.3** China—Total Loans

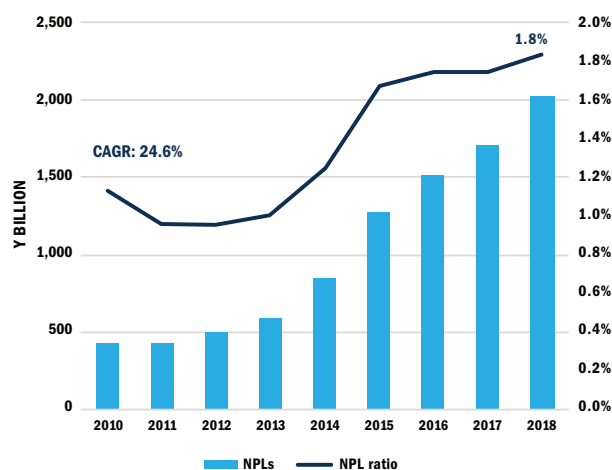
Source: Financial Soundness Indicators, IMF, and China Banking and Insurance Regulatory Commission.

and new drivers of growth can lead to productivity improvements. Moreover, the likelihood of a financial crisis unfolding in ways like other larger markets is considerably attenuated by the resiliency that the sheer size of China's economy affords, as well as the latitude available to the country's economic authorities to intervene helps to mitigate risks of potential and abrupt financial and macroeconomic shocks.

### Legal and Regulatory Framework

On June 1, 2007, China put into effect its Enterprise Bankruptcy Law (EBL), prior to which there was no formal bankruptcy law in the country. This was a watershed moment for China in that the EBL introduced concepts into its bankruptcy regime that previously did not exist. These concepts include, among others, the appointment of an administrator and creditor committee, balance sheet restructuring as an alternative to liquidation, and recognition of cross-border enforcement of bankruptcy court rulings and judgments. The new legislation brought China's insolvency regime closer to global standards.

The EBL is the first piece of bankruptcy legislation that uniformly governs state-owned enterprises (SOEs) and non-SOEs, including collectively-owned enterprises, private companies, Sino-foreign joint equity enterprises, Sino-foreign cooperative enterprises, and wholly foreign-owned enterprises. It does not cover individuals or partnerships.



**FIGURE 4.4** China—NPLs

Source: Financial Soundness Indicators, IMF, and China Banking and Insurance Regulatory Commission.

The following summarizes the EBL's main features:<sup>46</sup>

- Either a debtor or creditor may apply to the people's courts for bankruptcy protection on the grounds of debtor inability to honor all its debt obligations on a timely basis.
- The debtor and relevant creditors will appoint an independent administrator whose duties must be approved by the court and a separate creditor committee, if appointed.
- A nine-member creditor committee, including at least one employee or labor-union representative, will oversee the management, disposal, and distribution of the debtor's assets, and will adjudicate certain actions pertaining to these functions by the independent administrator.
- A petition to the court can be filed for the troubled company's balance sheet to be restructured instead of liquidated by the debtor, a creditor, or a shareholder holding more than 10 percent of the debtor's capital or liability.
- The recognition and enforcement of cross-border bankruptcy rulings and judgments applied to a non-bankrupt company in China is subject to certain conditions and is quite limited. Along these lines, it is important to note that China has not yet adopted the UNCITRAL Model Law on Cross-Border Insolvency.

While the EBL in China augurs well for the future treatment of bankruptcy situations, its implementation continues to be work in progress and bankruptcy cases are extremely rare in China, despite the EBL having been in place since 2007. Its successful implementation unquestionably requires the support of the local authorities.

Recently, the government of China requested the support of the World Bank Group's FCI GP to improve some aspects related to resolving insolvency and a diagnostic report was delivered to the Chinese authorities.

### Quality of Information

Undertaking a current distressed assets market assessment in China is made difficult by the scarcity of public information regarding operations of the AMCs and banks that may be interested in working with investors in structuring an NPL portfolio sale. While the CBIRC has taken actions to improve the recognition of NPLs by banks, both in terms of timeliness and nature of the assets to be considered as NPLs, specific total amounts, characteristics, and the actual tradeable amount are still challenging to assess. Given the sheer size of the country, data quality also may vary from province to province, which, among other reasons, will require investors to partner with local servicers, including law firms.

### Servicing Capacity and Investor Base

The servicing capacity in China is rather fragmented, as most of the servicers are focused on specific provinces, with no countrywide coverage, for three main reasons: (a) the large size of the Chinese market allows each province to offer the critical mass needed by the servicers to operate, (b) the specificities of the implementation of the legal framework in each province encourages servicer specialization, and (c) local market knowledge and a relationship network at that level is essential for NPL resolution.

Over the last decade, the servicing industry in China has been focused on two main types of players. First, the four national AMCs (and subsequently the provincial AMCs) developed the country's servicing capacity, complemented by a number of independent domestic servicers, both private and publicly owned. Second,

as the NPL market began to pick up over the last two years, some of the large international investors that have recently entered the market are establishing their own servicing capacity, either by acquiring or entering into strategic partnerships with existing independent servicers or by building their own recovery teams.

During the first wave of NPL sales in the early 2000s, several of the specialized international investors actively participated in the market. However, most left as the market slowed down, leaving the space in the hands of predominantly domestic players, with most activities carried out by local public and private investors. Today, China's distressed assets market continues to be dominated by authorized AMCs. Although there has been growth in the number of provincial AMCs, they remain challenged from a capital perspective, particularly when considering the potential volume of distressed debt that is expected to become available in the coming years.

In the past couple of years, foreign investors are beginning to show renewed interest in the Chinese NPL market with several high-profile buyers actively engaging in the acquisition cycle. On average, these transactions have been relatively small—likely undertaken to test the market as well as to establish servicing capabilities. However, larger deal sizes and a larger number of deals are available, and this environment is expected to develop as investor sentiment continues to build and as the regulator continues to support credit tightening by restricting shadow banking and offshore bond issuances, among other measures. In any event, given the large size of the opportunity, it is expected that more distressed assets investors will continue to enter this market in the near future.

### Going Forward

Despite the scarcity of publicly available information on companies and debt, the sheer size and anticipated growth of the distressed assets market in China combined with recent modernization of the legal and regulatory framework, promising indications of investor interest, and growing servicing capacity, qualify China as a prospective attractive market for distressed assets investors.

**BOX 4.2** DARP Involvement in China

IFC was active during the first wave of NPL sales in the early 2000s. This pre-DARP involvement did not follow a programmatic approach, but rather focused on supporting some of the initial efforts in the distressed assets space, including partnerships with two of the four national AMCs. IFC took a leading role in one of the first sales of distressed assets initiated by the government of China, the success of which established a precedent for future NPL sales and helped provide much-needed momentum to the development of the NPL market. IFC participated in a consortium (China One) that included Morgan Stanley, Lehman Brothers, and Salomon Brothers that established a partnership with Huarong AMC. Later, IFC invested in Rongde Asset Management Company (Ramco), a joint-venture AMC formed between China Huarong Asset Management Corporation, Deutsche Bank, and American International Group. Ramco was established as the first equity joint-venture AMC that was intended to be a long-term, multi-pool platform, allowing for the efficient acquisition, transfer, servicing, and resolution of NPLs. In addition, IFC invested in a second equity joint venture to continue supporting the development of the local distressed assets market with China Orient Asset Management Corporation and CFS Investment Holding, a wholly-owned subsidiary of General Electric. Following IFC's support to that first wave of NPL resolution in China, DARP has continued to participate more opportunistically in the market through some of its Asian regional platforms with Clearwater, ADM Capital, and Fortress. These DARP platforms have invested in several opportunities, including high-yield bonds and special lending. Now, after several years of no significant NPL activity in the country, DARP has re-engaged to extend its global strategy into this market, including developing the required servicing infrastructure as well as mobilizing capital and expertise for this space in China.

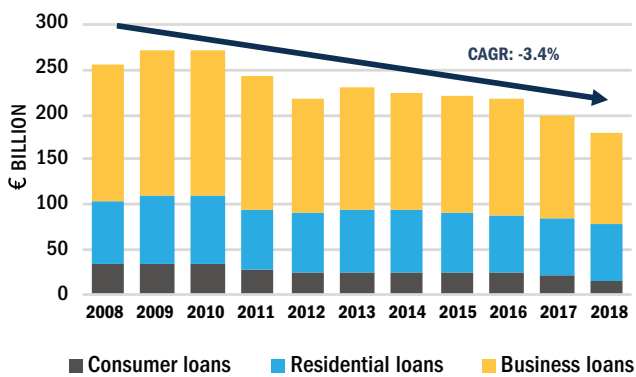
## Greece

### Market Size

Greece is one of the largest distressed assets markets in Europe. In the aftermath of one of the most severe liquidity crises in the recent history of developed markets, from 2010 onwards, asset quality deteriorated sharply. As of December 2018, Greece's asset quality was the worst of all countries in the EU with an NPL ratio of 45.4 percent, having grown at a CAGR of 18.8 percent since 2008 while credit fell at a CAGR of 3.4 percent over the same period. With NPLs at €81.8 billion (equivalent to approximately \$93.7 billion), only about half of this value was covered by cumulative reserves. The business segment of this stock amounted to €45.9 billion (44.7 percent NPL ratio); consumer loans accounted for €8.8 billion (53.0 percent NPL ratio); and the balance of €27.1 billion comprised residential loans (44.5 percent NPL ratio). Unlike in other EU countries (such as Ireland and Spain), in Greece NPLs are spread across all asset classes and systemic banks. This has been one of the main reasons why, unlike other countries, the concept of a public AMC has not materialized in Greece.

### Macroeconomic Outlook

Following one of the deepest and longest recessions in modern history, Greece's macroeconomic outlook is improving. In August 2018, the country graduated from the financial support program<sup>47</sup> as agreed between Greece and the three negotiation partners—also known as the “Troika”—the European Commission representing the European Union, the European Central Bank, and the IMF. After seeing real GDP contract by more than one-quarter (with government consumption contracting similarly, household consumption by 20 percent, and gross fixed investment by almost two-thirds), Greece's incipient recovery, underway since 2017, remains constrained by the very high level of nonperforming exposures in the banking sector (47 percent of outstanding loans). This limits banks' capacity to lend, constraining investment and contributed to sluggish growth and job creation. Even so, Greece's real GDP growth is forecast by the IMF at 2.2–2.4 percent per annum during the period 2019–20.



**FIGURE 4.5** Greece—Total Loans

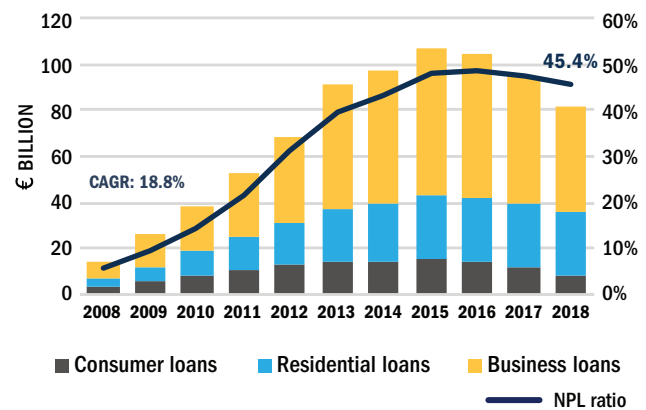
Source: Bank of Greece.

Despite the significant fiscal consolidation, government debt remains very high at 183 percent of GDP. However, three-quarters of this debt is owed to EU lenders on what are essentially concessional terms. The government also has a large cash buffer of €45 billion and has recently accessed financial markets with a well-received €2.5 billion bond issuance. On March 1, Moody's upgraded Greece's sovereign rating to B1 (stable outlook) from B3 citing an entrenched reform program, a strengthening economy, strong fiscal performance, and enhanced public debt sustainability.

### Legal and Regulatory Framework

The Greek legal and regulatory framework has undergone significant improvements in recent years to create a satisfactory environment for NPL transactions. The key changes include:

- Reforms of the Greek Code of Civil Procedure, passed and adopted between 2014 and 2017, were introduced to: (a) simplify the enforcement framework and expedite the auction process, (b) improve ranking and recoveries of secured claims, and (c) reduce enforcement costs.
- Improvements were introduced to enhance the effectiveness of the pre-bankruptcy rehabilitation process.
- Legislation was enacted enabling the licensing and regulation of non-bank service providers and loan



**FIGURE 4.6** Greece—NPLs

Source: Bank of Greece.

transfers. In December 2015, the so-called NPL law entered into force. It set out the framework for the establishment and operation of specialized NPL management companies—Loan Management Companies (LMCs), subject to licensing in accordance with a rigorous approval process, and Loan Transfer Companies (LTCs), which are not licensed and may purchase pools of NPLs if they have an agreement in place with an LMC. The NPL law is considered to have been the major “game changer” for the debt-servicing industry.

- The management and sale of all performing and non-performing loans were liberalized as of January 1, 2018.
- The option for OCWs was introduced.
- Also introduced were: (a) criteria-based safeguards to protect individuals and institutions from unwarranted civil/criminal liability as a consequence of their involvement in debt restructuring, (b) simplified process and documentation for the licensing and operating of servicing platforms for banking receivables, and (c) electronic auctions for foreclosed properties.

### Quality of Information

The information available on Greek debt obligations is well developed in accordance with accounting, regulatory, and reporting standards imposed by the EU.



**TABLE 4.2** Greece: Summary of NPL Sales

Portfolio	Eclipse	Venus	Amoeba	Earth	Arctos	Jupiter	Zenith	Galvin
Year	Oct-17	Mar-18	May-18	Jun-18	Oct-18	Oct-18	Dec-18	Jun-19
Seller	Eurobank	Alpha Bank	Piraeus	NBG	Piraeus	Alpha Bank	Eurobank	Piraeus
Asset class	Retail Unsecured	Retail Unsecured	SME Secured	Retail Unsecured	Retail Unsecured	SME Secured	Retail Unsecured	Retail & Commercial
Outstanding total balance (€ million)	2,900	3,700	2,100	5,200	2,300	1,200	2,000	27,000

Source: IFC.

### Servicing Capacity and Investor Base

Facilitated by the significant overhaul of the legal and regulatory framework, the servicing infrastructure in the country is being developed. Until two years ago, the servicing capacity in Greece was limited, with only a handful of local debt collection agencies and law firms. In fact, most of the NPL servicing was managed by the banks themselves. Over the past two years, during which servicing has been regulated, 17 servicing licenses have been issued by the National Bank of Greece. However, the development of servicing capacity takes time and, as such, real servicing capacity has not yet been significantly established, with many licensed servicers employing existing but unlicensed “sub-servicers” in order to perform collections activity. Nevertheless, it is expected that as these new players start ramping up their operations, the servicing infrastructure will grow to meet the market’s needs.

#### BOX 4.3 DARP Involvement in Greece

IFC adopted a wholistic approach to support the Greek financial system, with a two-pronged strategy to: (a) help capitalize banks with equity investments, and (b) help clean up their balance sheets through solutions provided by DARP. Along these lines, IFC is playing an active role to support the mobilization of capital and expertise in the Greek NPL market, both in the retail and corporate segments of the NPL market where IFC has already acquired two of the largest portfolios sold to date.

The Greek market is rapidly becoming more competitive as the first NPL portfolios are being sold, especially in the unsecured retail and secured corporate spaces. Table 4.2 summarizes the sales completed over the last two years in Greece. For the most part, the investors that are becoming active in the country are large, foreign-specialized investors attracted by major investment opportunities and the high levels of anticipated returns compared to other more mature markets, such as the United Kingdom, Spain, and Ireland. Recently, banks have started to explore more structured transactions to accelerate the disposal of their NPLs, including, for example, establishing strategic partnerships with investors for the management of their distressed assets through the carve-out of their servicing units coupled with long-term servicing contracts.

### Going Forward

As mentioned above, the first retail and corporate distressed assets sales have been successfully closed. As the new legal and regulatory framework is tested and the macroeconomic environment improves, together with increased certainty, investors will feel more comfortable investing and sellers will have more willingness to sell. In addition, banks and regulators are exploring new structures that allow for an increased volume of sales as well as generation of additional capital for banks. These include the securitization of NPL portfolios with different tranches, the introduction of guarantee schemes for these securitizations, as well as the spinoff and sale of banks’ recovery units.

## India

### Market Size

As of September 2018, the NPL stock of Indian banks reached 9.7 trillion Indian rupees (equivalent to approximately \$134 billion) or 10.8 percent of total credits. NPLs have grown at a CAGR of 34.8 percent from March 2010 to March 2018, exceeding the comparable growth rate of 13.8 percent of total loan volume originated by banks over the same time period. Problem loans have created a negative feedback loop that dampens credit expansion as well as financial inclusion, economic growth, job creation, and fiscal consolidation.

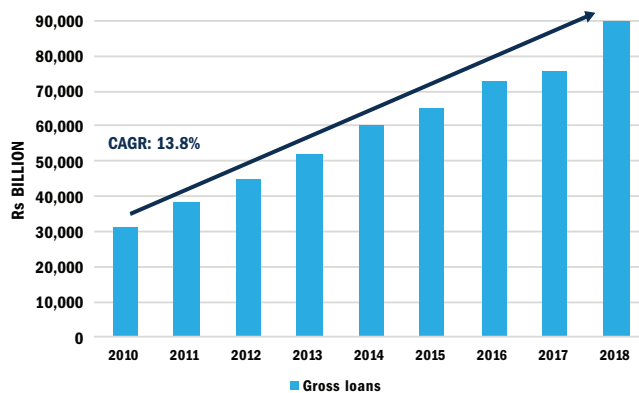
The NPL problem has precipitated a spike in loan-loss provisions, causing banks' profitability and capital to decline sharply. The banks' loan-recovery capacity remains weak, and efforts to contain the rise in NPLs have mainly involved write-offs, leading to credit growth in 2017 falling to its lowest rate in 60 years. While the problem is pervasive throughout India's banking sector, over 80 percent of total NPLs are held by public sector banks, thus creating an additional fiscal burden. With corporate loans accounting for about 90 percent of total NPLs, credit to this sector has been tightened. This has caused losses in both production and productivity, as many project sponsors are deferring planned investments in new projects or expansion and modernization of existing production

facilities. Many of the country's key strategic industries are in default, which results in a critical barrier to economic growth in India. However, there are signs that asset quality may improve over the next quarters as a result of recoveries from cases resolved under the new insolvency code.

Another relevant element to keep in mind is the instability of the non-bank financial company sector in India, which started in the second half of 2018, when Infrastructure Leasing & Financial Services, one of the largest NBFCs, defaulted on some of its obligations. This triggered an immediate shortage of liquidity across the entire sector that is affecting the capacity of NBFCs to keep growing their loan books, which may lead to a potential deterioration of their asset quality. Such deterioration is expected to have a greater negative impact on property developer and structured corporate loans, with a more limited effect on retail loans. All of this could contribute to an overall increase of the total NPLs in India, even above of the volume described here.

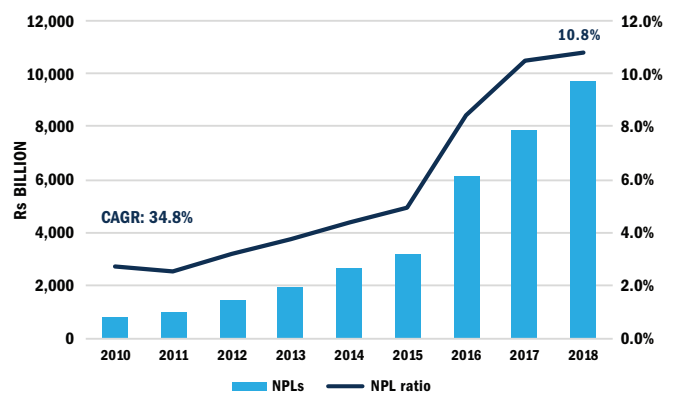
### Macroeconomic Outlook

India faced a confluence of negative factors that weakened economic performance in recent years. GDP growth rate slowed to 6.8 percent in FY2019 from 7.2 percent in FY2018, down from around 8.2 percent in FY2017. Despite a short-term slowdown, GDP growth is projected to strengthen to around 7.5–7.7



**FIGURE 4.7** India—Total Loans

Source: Reserve Bank of India.



**FIGURE 4.8** India—NPLs

Source: Reserve Bank of India.

percent during FY2020—23, driven by prudent macroeconomic policies and ongoing reforms. A pick-up in investment as corporate and bank balance sheets are cleaned up will support the recovery in economic momentum. However, economic weakness in FY2019 has already led to a delay, until FY2021, on plans to reduce the fiscal deficit to 3 percent of GDP—the target has been increased to 3.4 percent of GDP for FY2019 and FY2020. General government debt is high; in 2018 it was around 70 percent of GDP but is projected to decline over the medium term. Private debt, meanwhile, amounted to another 68 percent of GDP in 2017. Foreign exchange reserves, excluding gold, are \$396 billion—around seven months of import cover—providing the necessary cushion. Prudent macroeconomic policies, continuation of structural reforms, and improved investor confidence post elections should support capital flows and support maintaining exchange rate stability. However, the escalation of global headwinds—including a sustained and meaningful rise in global crude oil prices, the ongoing global growth deceleration, and intensification of global trade tensions—could lead to increased risk aversion, thereby exerting pressure on spreads and the rupee.

To revive private investment, strengthen the financial system, and arrest the slowdown in rural and urban consumer demand, the government needs to iron out supply side bottlenecks. This would include strengthening the goods and services tax revenues by further simplifying its structure and tightening compliance, improving operational efficiency of the public sector banks, strengthening the bankruptcy resolution process, supporting financial sector liquidity, channeling increased credit to SMEs, and improving the terms of trade for the agriculture sector.

### Legal and Regulatory Framework

The NPL issue has been recognized by the government of India (GoI) as an important issue that needs fast and effective resolution. Thus, over the past couple of years, the GoI has implemented a series of important reforms to revamp the legal and regulatory environment for distressed assets resolution, including:

- **Introduction of the new Insolvency and Bankruptcy Code (IBC).** The IBC, promulgated in 2016, provides for a clearly defined time-bound path for resolution, with a well-defined waterfall mechanism for payment of debt in case of liquidation of a company. It also facilitates setting up specialized courts and creates the role of the insolvency professional to deal with distressed assets cases on a timely basis through a restructuring process called the Corporate Insolvency Resolution Process. Since the new code was approved, several improvements have been implemented. Notably, a common concern in the early stages of the implementation of the IBC was the uncertainty about the continuing role of existing sponsors in these companies. As a result, in November 2017, the Reserve Bank of India (RBI) amended the IBC to prevent defaulting sponsors from bidding for their assets in resolution proceedings and regaining control at a deep discount. In addition, in February 2018, the RBI introduced significant changes in the handling of distressed assets by banks, including the overhaul of the distressed assets resolution framework by withdrawing all previous out-of-court restructuring schemes.
- **Amendment of the Banking Law.** The GoI issued an ordinance that gives wide-ranging legislative powers to the RBI to issue directions to lenders to initiate insolvency proceedings for the recovery of NPLs. Under this scheme, the RBI notified a list of 12 companies that were forced to go into bankruptcy proceedings, followed by another 28. Together, these forty companies represent around 60 percent of the total NPLs in the system.
- **Much more stringent NPL recognition and provisioning.** Among other requirements, the RBI enforced quarterly asset quality reviews to identify early stress and make provisions, while banks were required to provide for 50 percent for all assets referred to IBC. Furthermore, a default against one lender now triggers classification of the account as an NPL by all other lenders, even if their accounts are classified as current.

In addition, efforts have been directed to establishing an AMC to increase asset resolution capability in the country. The objective of the AMC is twofold: (a) to transfer NPLs from banks to AMC-managed funds at market price instead of book value to avoid market distortions, and (b) to do so before these NPLs

are referred to the National Company Law Tribunal (NCLT), thus helping retain value and freeing up NCLT capacity, making the overall distressed assets resolution process more efficient. The AMC will aim to resolve NPLs above Rs5 billion (equivalent to approximately \$72 million) under consortium

#### **BOX 4.4** Insolvency, Bankruptcy, and NPL Resolution Progress in India

**By Sriram Balasubramanian**

The Insolvency and Bankruptcy Code (IBC) was one of the most anticipated reforms by the Indian government in recent years. With an increasing number of NPLs creating enormous pressure in the banking sector, there was a need for a streamlined insolvency and bankruptcy process.

##### ***How has the performance been?***

The NCLT, established under the Companies Act 2013 and implemented in June 2016, is a quasi-judicial body with eleven benches across India that adjudicates issues relating to stressed companies, expected to be scaled up in the near future. As of March 31, 2019, 1,858 corporates had been admitted into the resolution process. Of these, 97 have had their resolution plan approved, 243 were closed on appeal or review, and 378 resulted in liquidation. The remaining 1,143 cases are undergoing resolution. The lenders of the 97 resolved cases, on average, received 51 percent of their outstanding debt, while it took more than 270 days for approximately 70 percent of these cases to get their resolution plan approved. These cases are filed in NCLT by creditors under the aegis of the Insolvency and Bankruptcy Board of India<sup>48</sup> (IBBI). Some of the significant insolvency resolutions include Bhushan Steel Ltd., which was acquired by the Tata Group for a majority stake. Lenders received around 63 percent of their outstanding debt. As IBBI matures into an organization dealing effectively with stressed assets, there has been a considerable improvement in its public perception.

##### ***What are the challenges? How can it be made better?***

The first challenge relates to the ability of sponsors to regain control of their companies, often at steep discounts, or disrupting the process. Despite an amendment made to the IBC in 2017, there are still loopholes that need to be addressed to bolster transparency by barring sponsors from having any

direct or indirect interest in the companies after going through the IBC process.

The second issue involves the integration of insolvency resolution professionals (IRPs) into stressed companies. There have been instances of backlash between the sponsors and creditors with the IRPs as they take control of the companies to initiate the insolvency proceedings. Even though NCLT courts have helped IRPs in these cases, there should be a more robust mechanism to protect IRPs when doing their jobs. Stringent action should be taken by the IBBI in response to sponsors who indulge in such actions.

The third challenge regards legal processes. Six of the 12 biggest cases are stuck in legislative processes in various courts in the country. Even if the law mandates that within 270 days the processes must be completed, the slow legal system in India works against the IBC. Some of the companies are appealing the verdicts by NCLT in the Supreme Court, delaying the process further. More fast-track courts are needed to handle the high number of cases that come to NCLT for initiation of insolvency proceedings, as is a more coordinated mechanism for resolving these pending cases between the Supreme Court and the NCLT.

The fourth major challenge is the ability of local banks to take haircuts to resolve their NPLs. While the recent recapitalization drive by the government is welcome, more haircuts will be required until the IBC mechanism is streamlined and NPL issues are sorted out. Furthermore, bankers' fear of being investigated for their actions to resolve these cases also serves as a deterrent in the complex bureaucratic system in India. It is important that the regulator provides unambiguous support for the bankers involved in terms of both legal and job protection for doing their respective jobs.

lending. It will be an independent entity with a robust governance structure with the expectation that at least 51 percent is privately owned. The AMC has been already incorporated under the name of Sashakt India Asset Management Limited.

In addition, recently a new Inter Creditor Agreement (ICA) has been implemented that also aims to help overcome some of the existing issues in the resolution of distressed assets. The ICA seeks to resolve loans of Rs500 million (equivalent to approximately \$7.2 million) or more which are under consortium lending. The approach of the ICA is completely in line with IBC and existing regulations and focuses on arriving at a consensus among multiple lenders and reducing the delays in resolution that exist today. For that, roles have been assigned to each of the key stakeholders involved to ensure efficiency in the pre-resolution process. As of December 2018, 34 banks and other financial institutions had signed up the ICA.

It is important to note that in April 2019 the Supreme Court of India overruled the RBI circular from February 12, 2018, which stipulated that banks unable to arrive at a debt-resolution plan within 180 days for loan accounts of Rs20 billion (equivalent to approximately \$287 million) or more had to bring the defaulter into the IBC process. The Court judgment stated that the provisions in the RBI's circular were ultra vires, that is, beyond the RBI's legal authority, and all cases currently in the resolution process could therefore not continue through the IBC process. On June 7, 2019, RBI issued another circular by which it revised its guidelines on distressed assets resolution, facilitating workouts and out-of-court negotiations among stakeholders. Some of the key changes are: (a) the size threshold of cases for which a debt-resolution plan needs to be implemented within 180 days has been lowered to loan accounts of Rs15 billion (equivalent to approximately \$215 million), (b) the share of lenders needed to approve the debt-resolution plan has been reduced, (c) lenders can reverse provisions at the time of filing and at the time admission of the case under IBC, and (d) after a default, the number of days that lenders have to discuss and decide on the resolution plan has been increased to 30 days.

## Quality of Information

While laws for recognition and provisioning of NPLs in India are at par with Basel III, banks have traditionally underreported NPLs. However, the RBI has become more stringent in the classification of NPLs and insists on standardized NPL reporting. These measures have created an enabling environment that can attract private capital at scale for investment in distressed assets resolution.

## Servicing Capacity and Investor Base

On paper, the servicing infrastructure in India has been established for over a decade. In fact, more than a dozen Asset Reconstruction Companies (ARCs) have been operating in the country for several years. However, most of these ARCs limited their strategies to the pure liquidation of the underlying assets. Therefore, not much actual servicing capacity and workout expertise was developed. As a result of the implementation of the IBC, a new generation of ARCs and new distressed assets managers are being established. These include a few of the previous ARCs that have stayed active, coupled with

### BOX 4.5 DARP Involvement in India

IFC and the World Bank have developed a programmatic approach that includes a series of initiatives to help develop a distressed assets market in India. The World Bank Group's FCI GP is providing technical assistance to strengthen the credit environment, particularly by improving implementation and operational use of the IBC to improve debt recovery. For instance, they have assisted IBBI in developing its insolvency practitioner regulation. IFC has been systematically supporting a range of solutions for distressed assets through its DARP program. In 2015, IFC invested in a non-bank financial company, Altico, that focuses on providing special lending to stressed SMEs in partnership with Clearwater Capital Partners. In the same year, IFC, together with Encore Capital, set up an ARC that targets distressed assets resolution in the retail and MSME sectors. Finally, in 2018, IFC invested in IndiaRF, a joint-venture fund between Bain Capital Credit and Piramal Enterprises, focused on restructuring large businesses in distress.

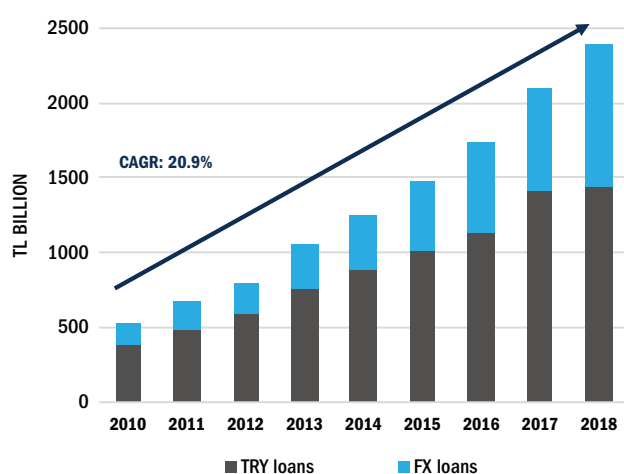


a number of new ARCs that are being established by new entrants in the market.

Competition in the distressed assets market in India is still limited. International investors have started to establish their presence in the market and, more often than not, are doing so through partnerships involving domestic investors with the goal of combining track record and expertise in distressed assets resolution with the required local knowledge to successfully operate in India. Most of these new investors are focusing their attention on the larger distressed cases that are coming to market. However, in the smaller corporate spaces, as well as the retail and SME space, competition is still quite limited.

### Going Forward

As mentioned above, resolving the issue of elevated levels of NPLs is a priority for the GoI. With the new insolvency code in place and the active role of the RBI, some of the largest distressed assets situations have already been or are on their way to being resolved, despite taking more time than anticipated. A positive outcome will result in more trades coming to market, both related to large corporate and SMEs, while in parallel new players will want to play a role in the Indian distressed assets market. In addition, bilateral structured transactions, which require more skilled asset managers, are also taking place.



**FIGURE 4.9** Turkey—Total Loans

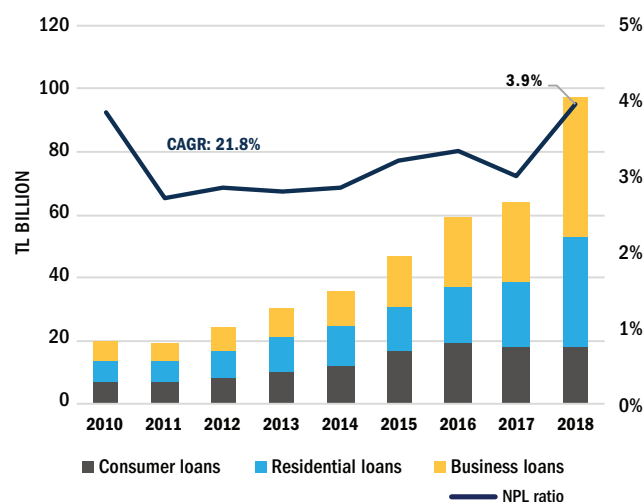
Source: BRSA.

## Turkey

### Market Size

Following a decade of elevated economic growth in Turkey, the total volume of loans increased significantly because of rising demand for credit, both from individuals and households, as well as SMEs and corporates. In December 2018, total loans in Turkey reached 2.4 trillion Turkish lira (equivalent to approximately \$453 billion), having increased at a CAGR of 20.9 percent since 2010. The main drivers behind such growth were commercial and SME loans. In addition, the volume of foreign-currency denominated loans has also been growing in Turkey, which poses an increasing risk to the credit quality of the overall loan book given the significant volatility that the Turkish lira has been experiencing.

Because of the recent negative macroeconomic situation, the NPL levels have continued to rise in Turkey. The total stock of NPLs grew from TL 64 billion (equivalent to approximately \$16.9 billion) in December 2017, representing a an NPL ratio of 2.9 percent, to TL 97 billion (equivalent to approximately \$18.3 billion) as of December 2018, representing an NPL ratio of 3.9 percent. In addition, based on the result of a stress test performed by the Banking Regulation and Supervision Agency (BRSA), the NPL ratio could reach as high as



**FIGURE 4.10** Turkey—NPLs

Source: BRSA.

6 percent by the end of 2019. To add to the potential size of the NPL problem in Turkey, there is the worrisome increase of Stage II loans (defined as loans whose credit risk has raised significantly). In fact, total Stage II loans within the thirteen largest banks in Turkey have reached TL 238.5 billion (equivalent to approximately \$45.1 billion) in December 2018 and are expected to increase further to an estimated TL 275 billion (equivalent to approximately \$47.3 billion) in December 2019. This rapid increase in Stage II loans is a clear symptom that the quality of the loans across the Turkish banks is rapidly deteriorating. Therefore, when adding the loans already classified as NPLs and the Stage II loans, the total ratio gets closer to 15 percent, which is a clear indication of the large NPL problem in the country.

### Macroeconomic Outlook

Macroeconomic and political vulnerabilities continue to weigh on Turkey's economic outlook. Currency weakness recurred ahead of the March 31, 2019 municipal elections, driven by renewed tensions with the United States, a sudden reduction in already low levels of gross and net foreign exchange reserves, and ongoing unconventional anti-inflationary policies. Uncertainty was not eased by local elections held in May, given victories by the opposition in several cities and a decision to rerun Istanbul's municipal election on June 23. On the economic front, a recession in the second half of the year reduced full-year growth in real GDP to 2.6 percent in 2018, the lowest since 2009. Output is set to contract by 2.5 percent this year, according to the IMF, as tight credit continues to negatively impact domestic spending along with high interest rates and inflation. Low foreign exchange reserves will require the Central Bank of Turkey to keep interest rates high to steady the lira and prevent 12-month inflation from rising from 18.7 percent in May. The IMF projects the economy to recover in 2020, with growth averaging just 3.1 percent between 2020 and 2024, that is, 3.7 percentage points below the 2010–17 average. There are significant downside risks to the outlook, however, with higher inflation expectations, constrained Turkish lira bank credit given increasing dollarization of deposits, significant uncertainty about bank asset quality including future capital positions, and significant external and domestic challenges.

### Legal and Regulatory Framework

The Turkish Execution and Bankruptcy Law, promulgated in 1932, has been amended many times since enactment, most recently in March 2018. Key amendments in the latest reform included the abolishment of the postponement of bankruptcy mechanism and the modernization of the already existing restructuring proceeding (*Konkordato*), which had barely been used in recent years. *Konkordato* is a court-led process aimed at restructuring the outstanding debt of viable but distressed companies. Either the debtor or a creditor can apply to the court to put the debtor into *Konkordato*.

The *Konkordato* is not suitable for many large-scale corporate group restructurings, as it is only available to restructure obligations of a single legal entity. In addition, two other downsides are: (a) the excessive degree of involvement of the court and (b) the strong protections afforded to privileged creditors, including tax and labor claims.

To mitigate the shortcomings identified in the *Konkordato*, Turkish authorities decided to promote out-of-court restructurings as a meaningful alternative to address corporate distress. The ultimate objective was to replicate the experiences observed under the Istanbul Approach in the early 2000s, when the Turkish banks were able to work with other financial institutions outside of formal procedures to restructure their outstanding debts. With this objective in mind, the BRSA enacted the Regulation on the Restructuring of Debts to the Financial Sector (Regulation). The Regulation instructed the Turkish Banking Association to develop a Framework Agreement establishing the general principles and rules applicable to the restructuring of large corporate debtors by domestic financial institutions. The Framework Agreement was signed in October 2018 by the Turkish banks, accounting for 90 percent of the total loan volume in the market. As opposed to the *Konkordato*, the Framework Agreement allows the restructuring of multiple debtors in the same corporate group as part of a single process. Some of the most important features of the Framework Agreement include:<sup>49</sup>

- A standstill on framework creditors upon application by a debtor to start a restructuring

- The formation of a consortium of framework creditors
- A cram-down mechanism where dissenting framework creditors can be forced to reschedule their debts if two-thirds (by value) of the consortium of framework creditors enter into a financial restructuring agreement; higher thresholds are required for specific restructuring measures
- The obligation on all framework creditors to provide new money to the debtor if such decision is approved by lenders representing 90 percent (by value) of consortium framework creditors
- A requirement to complete the process in 90 days, a period that may be extended by 60 additional days by the consortium of framework creditors
- A limit to debtors of two applications within the two-year period in which the Framework Agreement remains in force

Although the Regulation was a strong endorsement to out-of-court restructuring in Turkey, a number of key factors remain unclear, including whether creditors that have not signed up to the Framework Agreement may be bound by agreements adopted by the majority, especially international lenders. The Framework Agreement permits the participation of international lenders in Turkish restructurings, but it explicitly states that they are not bound by the creditor voting matters under the Framework Agreement unless they have explicitly elected to opt in. Other questions remain, including details of the viability test that the debtor needs to comply with to access the procedure and successfully approve a restructuring plan.

The lack of tax incentives and the excessive disclosure requirements imposed on distressed applicants have prevented the adoption of any restructurings under the Framework Agreement during its first months of operation. As of June 2019, the authorities were considering the possibility of adopting a law that would address these shortcomings.

### Quality of Information

Generally speaking, the quality of information available is adequate. However, given the increasing volume of Stage II loans, as described above, it has become clear that there is a lack of clarity on what

constitutes an NPL and a Stage II loan, showing a gap between local and international practices with respect to NPL classification. As a result, official NPL figures may not reflect the actual level of NPLs on banks' balance sheets, as many Stage II loans are loans that have been restructured or that are benefiting from standstill provisions.

### Servicing Capacity and Investor Base

There is a long tradition of NPL sales in Turkey. Sales to the local asset management companies started in 2004, when a large stock of NPLs resulting from the financial crisis of 2001 was sold by the Savings Deposit Insurance Fund. This sparked the creation of the NPL market in Turkey. Following some regulatory changes, in 2008 regular sales of NPLs to AMCs by banks and other financial institutions started. Since then, it is estimated that a total NPL volume of TL 38 billion (equivalent to approximately \$6 billion) have been sold to AMCs.

Enabled by the development of the NPL market, a number of AMCs were established. Currently there are sixteen active AMCs, although the two leading ones, Hayat and Gelecek, have the lion's share of the market.

Historically, the bulk of these sales have been in unsecured retail NPLs, the asset class in which many

#### BOX 4.6 DARP Involvement in Turkey

Since the inception of the market in 2008, DARP has closely followed the market, but, given the high levels of liquidity that the AMCs have traditionally enjoyed, there has not been a market need for IFC to engage. However, following the country's macroeconomic deterioration and the reduction in available liquidity to AMCs from local banks, coupled with the rising level of NPLs, DARP is getting more involved in both (a) collaborating with other units of the World Bank Group to support the Turkish authorities in the development of an adequate regulatory framework for NPL restructuring and (b) exploring areas where it can play a role to support the development of the required resolution infrastructure and the mobilization of capital from private sector distressed assets investors.

of the AMCs have specialized. However, this new wave of NPLs is expected to be composed mostly of secured SME and corporate loans. Therefore, there is a potential lack of resolution infrastructure for these asset classes that will have to be developed.

It is worth noting that AMCs are not only pure servicing companies, but also investment companies, as they must acquire the NPLs on-balance sheet. Therefore, this poses a potential impediment for foreign investors to enter the market. In fact, the investor base has been traditionally dominated by local investors.

### Going Forward

As the NPL problem becomes more acute in Turkey, a number of different options are being explored to reduce the burden that such a large stock of NPLs is imposing on lending in the economy. Some of these options are:

- **Sales to AMCs:** This has been a very common avenue used by financial institutions to dispose of their NPLs. However, the bulk of these sales has involved unsecured retail NPLs, which raises the question of whether AMCs are equipped to deal with the increasing volume of potential sales of SME and corporate NPLs.
- **Debt-to-equity swaps:** For certain large exposures, where there is more than one bank lending to a common borrower, debt-to-equity swap structures are being explored to be able to take control of the company and implement a sound restructuring plan under new management. So far, these are being considered in the case of energy and real estate related exposures.
- **Securitizations:** Following the example of what has happened in other markets such as Italy, Ireland, or Spain, banks are exploring securitizations as a mechanism to offload large volumes of NPLs. However, securitization is currently only available for performing loans, while the domestic investor base is insufficient to absorb the expected volumes. Furthermore, offshore securitizations looking to attract larger investors are still very costly.

## Ukraine

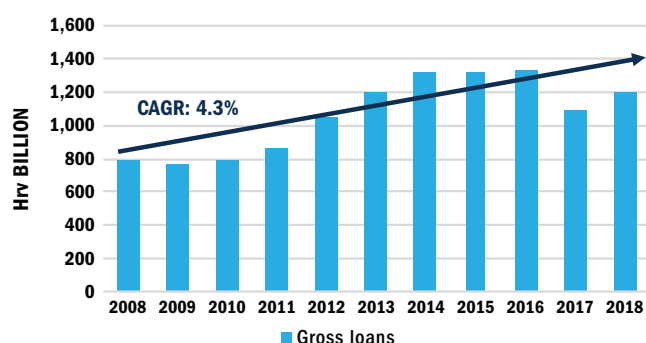
### Market Size

Ukraine's NPLs were reported at 630.8 billion Ukrainian hryvnias (equivalent to approximately \$22.8 billion) in December 2018, with an NPL ratio of 52.8 percent. In addition, the Deposit Guarantee Fund, established in 1998 to manage the assets of the insolvent banks in the country, has an additional approximately \$20 billion of NPLs under management. While NPLs have been increasing at a CAGR of 35.3 percent since 2008, credit growth has been lagging well behind, increasing at a CAGR rate of 4.3 percent over the same period. Legacy foreign-currency denominated loans issued years ago account for close to half of corporate NPLs and about three-quarters of retail NPLs.

### Macroeconomic Outlook

Ukraine's economic outlook remains uncertain. The 14-month, \$3.9 billion IMF standby program approved in late 2018, has bought time by providing a policy anchor and much-needed funding. However, medium-term risks loom large. On April 21, 2019, Volodymyr Zelenskyy, a comedian with no political experience, won a landslide victory to become the next president of Ukraine. On May 20, 2019 he was inaugurated and promptly dissolved parliament. The new parliamentary election is set for July 21, 2019. As a result of the elections, the first review of the IMF program has been delayed, postponing much-needed disbursements. Ukraine has substantial external financing needs with principal payments on government and private external debt due in 2019 and in 2020 amounting to \$15.9 billion and \$18.7 billion, respectively. IMF funding, therefore, is essential for sustaining debt servicing and accessing international capital markets.

Real GDP growth picked up to 3.3 percent in 2018 from 2.5 percent in 2017, partly driven by an unusually high harvest. The IMF forecasts growth to slow to 2.7 percent in 2019, before increasing to 3 percent in 2020. However, the outlook is subject to downside risks, in particular from a lack of progress on structural reforms, political risks, and the continuing conflict in eastern Ukraine. Inflation remains high, averaging 11 percent in 2018, well above the 5 percent target



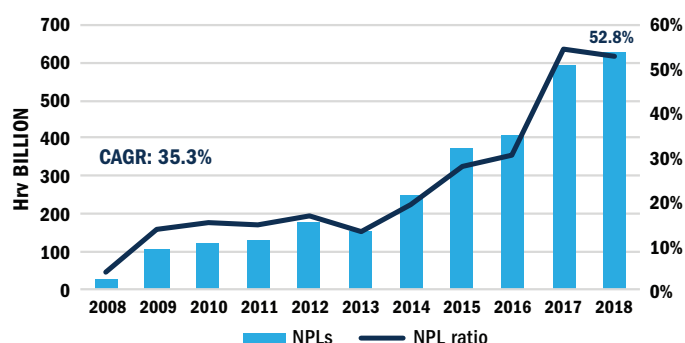
**FIGURE 4.11** Ukraine—Total Loans

Source: Financial Soundness Indicators, IMF.

which, accompanied by a widening external deficit, led to aggressive monetary tightening in 2018. Even though international reserves have increased over the past four years, they only account for three months of imports, or 66 percent of the IMF's adequacy metric. Beyond 2020, Ukraine faces external challenges related to the loss in fees for transiting Russian natural gas to Europe, potentially increasing depreciation pressures (consensus forecast a 11.6 percent depreciation against the U.S. dollar over the next two years). The new government will likely need to secure a larger IMF program to meet escalating external debt servicing needs beyond 2020, when the current IMF program is due to expire.

### Legal and Regulatory Framework

Ukraine's new law on financial restructuring (approved by its parliament on June 14, 2016 and put in place October 19, 2016) was drafted with the help of both the European Bank for Reconstruction and Development (EBRD) and the World Bank. Under the new law, lenders and borrowers can restructure their loan agreements through voluntary out-of-court mechanisms. The law aims to help distressed Ukrainian companies regain viability through mechanisms such as loan rescheduling, partial-debt forgiveness, and the conversion of debt to equity. A limited standstill on lender action is provided as well as protection to borrowers from new bankruptcy proceedings while restructuring negotiations are in progress.



**FIGURE 4.12** Ukraine—NPLs

Source: Financial Soundness Indicators, IMF.

A locally based administrative secretariat has been set up and is responsible for managing the restructuring framework, including processing individual restructuring cases. The law also provides for an arbitration committee to manage any disputes between parties by appointing an independent and qualified arbitrator.

In addition, a March 2017 review of the overall legal and regulatory framework for distressed assets was conducted by the World Bank Group and updated in early 2018. The 2017 review identified 17 areas for improvement.<sup>50</sup> The 2019 monitoring update found that progress had been made in several areas with other areas still needing improvement. The main areas where almost definitive progress was achieved included debt enforcement and foreclosure, the tax regime, as well as public registers. Other areas where significant progress was recognized include corporate and household insolvency and restructuring, debt counseling and outreach, as well as NPL governance and workout.

In April 2019, the new insolvency code was approved and will come into force later in the year. This code revamps the Ukrainian insolvency system and introduces, for the first time in Ukrainian history, a personal insolvency process. While this amendment intends to strengthen the development of a robust legal and regulatory framework for NPL resolution in Ukraine, its adequate implementation (strengthening the performance of courts and insolvency administrators) will be critical to improve the system in practice.



## Quality of Information

Data collection in Ukraine is disciplined in most areas, but the quality of information suffers from legacy regulations (including definitional problems, such as for NPLs) as well as from ambiguous and inconsistent banking practices. Furthermore, the lack of public registries and absence of registration requirements for loan sales place limits on the data available for assessing meaningfully the commercial potential of alternative distressed assets investment strategies prior to undertaking transaction due diligence. These problems do not preclude investor interest but raise the upfront costs of transactions.

## Servicing Capacity and Investor Base

The distressed assets market in Ukraine is embryonic, as is the servicing infrastructure of the country. After a few years during which some servicers were established by both local and international investors, with some of them even expanding their operations internationally, the development of the servicing infrastructure has recently stalled. As the regulatory framework is strengthened and the need to clean up the banks' balance sheets becomes increasingly pressing, activity in the servicing industry is picking up, with some transactions recently taking place.

Similarly, the potentially active investor base in Ukraine is still very limited, mostly involving local investors looking to diversify their asset base. International investors, for the most part, are not yet comfortable enough to take on significant exposure

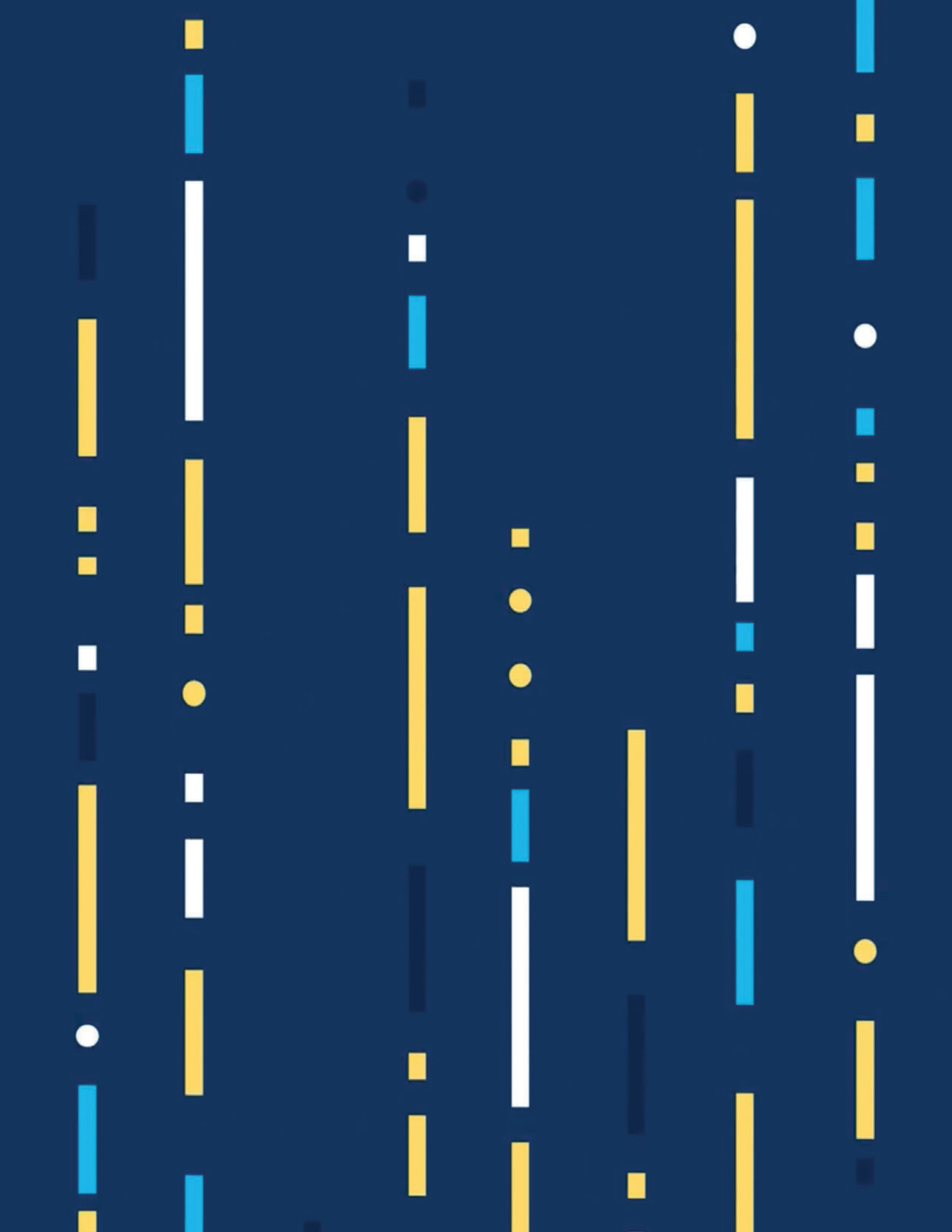
### BOX 4.7 DARP Involvement in Ukraine

Shortly after the global financial crisis, DARP identified Ukraine as one of the economies where it could play a significant role in developing a distressed assets market. Several attempts were made to put in place structures for acquiring and resolving NPLs. However, while the market size was sufficient, neither the quality of the information nor the legal and regulatory framework allowed for transactions to be consummated. Since then, DARP has worked closely with the World Bank Group's FCI GP to identify improvements that should be implemented for developing a distressed assets market. As these operational building blocks are put in place, DARP is seeking ways to extend its global strategy to Ukraine.

to this market. Consequently, the level of competition needed to develop an orderly and efficient distressed assets market will still take time.

## Going Forward

The framework for investing in distressed assets in Ukraine is not yet fully in place. However, the fact that the different stakeholders are aligned to undertake the required improvements, together with a large volume of NPLs and a recovering economy, makes it highly likely that attractive investment opportunities will be identified in the short- to mid-term, especially in asset classes that are less reliant on the judicial system. ■



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## CONCLUSION

Increasingly, high NPL levels in emerging economies are limiting the ability and appetite of financial institutions to extend new credit. Consequently, across emerging markets, access to financing is significantly reduced, the stability of the financial systems of these economies is threatened, and their economic growth or recovery is severely hindered. In this context, robust distressed assets markets are essential for recycling these large amounts of non-productive assets, allowing economies to restore financial stability and enable economic growth. Given the magnitude and the severity of the issue, collaboration among all stakeholders involved, including, including both the public and private sectors, is critical.

DARP has been playing a crucial role in creating and developing such distressed assets markets as a tool to foster economic development across emerging markets. As part of its strategy, DARP has been focusing on two main pillars. First, it has been building essential servicing infrastructure and resolution capacity, the lack of which is a major bottleneck for the development of vibrant distressed assets markets. Second, it has been mobilizing the required capital and expertise from the private sector, both internationally and in local markets, to have a meaningful impact on the resolution of these large volumes of NPLs.

One of the key aspects of DARP's success has been the close collaboration with the World Bank to

foster and promote the development of robust and credible insolvency and legal resolution frameworks—prerequisites for well-functioning distressed assets markets. Moreover, collaboration in setting up well-designed AMCs effectively complements private sector efforts led by DARP.

In addition to the significant development impact achieved by creating these distressed assets markets, there are attractive investment opportunities. And while opportunities for distressed assets investments are present across all emerging markets, countries such as Brazil, China, Greece, India, Turkey, and Ukraine currently warrant special consideration for investors. DARP will also continue to expand its reach in underserved regions such as Sub-Saharan Africa and MENA, contributing to making these markets more attractive for the private sector.

Much has been achieved by DARP with support from various partners and stakeholders. However, given the scale of the NPL issue, much remains to be done for emerging economies to regain financial stability and economic growth. In pursuing its goal to create and develop strong distressed assets markets, DARP will continue to exercise its leadership in this space, leveraging its unique global servicing infrastructure and its capacity to mobilize private sector players. ■

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- <sup>31</sup> For instance, banks will wait for the AMC to “give them a better deal.”
- <sup>32</sup> For instance, assets may be grouped by specific location, borrowers’ repayment capacity, maturity, and assigned a time frame for disposal.
- <sup>33</sup> Example in the NAMA act (Article 10): NAMA should “deal expeditiously with the assets acquired by it and protect or otherwise enhance the value of those assets in the interest of the State.” Section 221 states that any attempt to influence NAMA is an offence.
- <sup>34</sup> Providing market-based compensation to management has proven a challenge to many AMCs particularly during times of fiscal constraint. Danaharta instituted staff bonuses tied to meeting Key Performance Indicators. More recently, BAMC came under fire when it was disclosed that key staff members were receiving fees from BAMC borrowers for services such as directorships as part of their compensation. Beyond compensation, another important feature is the legal protection of their staff to allow them to pursue recovery actions effectively.
- <sup>35</sup> The European Commission’s recently published AMC blueprint provides a comprehensive discussion of reporting requirements to meet both EU and national standards.
- <sup>36</sup> For instance, an oversight committee composed by three representatives (one from the Ministry of Finance, one from the Central Bank, and one from the Securities Commission) did oversee, approve, and terminate appointments of special administrators by Danaharta.
- <sup>37</sup> Out of court workouts are nonjudicial, private contractual arrangements between the debtor and its creditors (all or just some of the creditors). They are not typically provided for in insolvency legislation, but are instead the result of consensual negotiations, which is why many workouts are considered “informal.” Parties are free to negotiate the terms of their restructuring agreement without involving the court. This typically means that workouts are flexible, fast, and less expensive than litigation.
- <sup>38</sup> Directive 2014/59 EU on bank recovery and resolution; EU regulation 806/2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund.
- <sup>39</sup> Impaired Asset Communication, Section 40.
- <sup>40</sup> Chaebols are family-owned large conglomerates which dominated the South Korean economy and played a significant role in politics (for example, Daewoo, Hyundai).
- <sup>41</sup> Reform movement in the post-Suharto era.
- <sup>42</sup> Throughout this chapter we have used the foreign exchange rate corresponding to the periods referred to in each specific section. *Source: Reuters.*
- <sup>43</sup> Some investors, however, will risk further declines in asset values to make opportunistic plays.
- <sup>44</sup> Quality includes having information on borrowers and collateral that is timely (regularly updated), comprehensive and reliable.
- <sup>45</sup> The rating system in Brazil not only considers arrears, but also the borrower’s risks: financial and economic situation, indebtedness level, capacity to generate results, etc. It also considers the nature of the transaction and collateral, if any. The scale goes from AA to H, with AA being the highest quality.
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## FURTHER READING

Additional reports about investing in challenging markets, the role of technology in emerging markets, as well as a list of EM Compass Notes published by IFC Thought Leadership: [ifc.org/thoughtleadership](https://ifc.org/thoughtleadership)



### Creating Impact: The Promise of Impact Investing

April 2019, 82 pages

Impact investing has emerged as a significant opportunity to mobilize public and private capital into investments that target priority development needs, particularly in emerging markets. Investors are increasingly looking to invest with impact by aligning their strategies to achieve the UN Sustainable Development Goals. To better understand what it would take to scale up credible impact investing, IFC published the “Creating Impact: The Promise of Impact Investing” report, which offers the most comprehensive assessment to date of the potential global market, along with practical suggestions for next steps.



### Reinventing Business Through Disruptive Technologies: Sector Trends and Investment Opportunities for Firms in Emerging Markets

March 2019, 108 pages

Technology disrupts and transforms. And disruptive technologies are critical to achieving the Sustainable Development Goals, many of which can be advanced and accelerated through technological innovations.

For a comprehensive examination of the ways these innovations alter private sector business models in emerging markets, IFC conducted a tour of the technology horizon in eight selected sectors—power, transport, water and sanitation, digital infrastructure, manufacturing, agribusiness, education, and financial services—and six selected themes, from gender and climate-smart cities to e-logistics and personal identification, among others.

This report examines each of these sectors and themes in terms of what true disruption looks like, which technologies are most likely to have a dramatic impact, and the specific opportunities they offer. It also identifies the challenges and constraints that will need to be surmounted if the private sector is to seize these opportunities. Lastly, it presents how IFC supports companies and investors in their efforts to enter into or expand in emerging markets.



## Blockchain: Opportunities for Private Enterprises in Emerging Markets

January 2019 (Second and Expanded Edition), 88 pages

Over the course of two years, IFC worked with key influencers and experts in the worlds of distributed ledgers and digital finance to create a series of nine papers examining the potential and perils of blockchain. An initial report with six chapters was published October 2017. Since then, three additional in-depth notes have been added to broaden and deepen our understanding of this burgeoning technology, its enormous potential, and its many challenges. These documents collectively examine the general contours and technology underlying blockchain and its implications for emerging markets.

Specifically, this report provides an examination of blockchain implementation in financial services and global supply chains; a regional analysis of blockchain developments in emerging markets; and a new focus on blockchain's ability to facilitate low-carbon energy solutions, as well as a discussion of the legal and governance issues associated with the technology's adoption.



## How Technology Creates Markets: Trends and Examples for Private Investors in Emerging Markets

April 2018, 100 pages

Technological progress is often associated with the creation of novel and useful products through innovation and ingenuity. Yet in many emerging markets, including low-income economies, it is often more common to adopt, adapt, and scale technologies that were created elsewhere.

This report focuses on how technology is contributing to market creation and expansion in emerging markets. It includes analysis and examples of increased access to products and services—energy, financial, and other types—that have been unavailable to large population segments. The report also looks at the impact of technology on market participants, ecosystems, and existing players.

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# Additional EM Compass Notes

JUNE 2019

**Note 68:** Basic Business Models for Banks Providing Digital Financial Services in Africa

APRIL 2019

**Note 67:** The Case for Responsible Investing in Digital Financial Services

MARCH 2019

**Note 66:** Blended Concessional Finance: Governance Matters for Impact

**Note 65:** Natural Gas and the Clean Energy Transition

FEBRUARY 2019

**Note 64:** Institutional Investing: A New Investor Forum and Growing Interest in Sustainable Emerging Markets Investments

JANUARY 2019

**Note 63:** Blockchain and Associated Legal Issues for Emerging Markets

**Note 62:** Service Performance Guarantees for Public Utilities and Beyond—An Innovation with Potential to Attract Investors to Emerging Markets

NOVEMBER 2018

**Note 61:** Using Blockchain to Enable Cleaner, Modern Energy Systems in Emerging Markets

**Note 60:** Blended Concessional Finance: Scaling Up Private Investment in Lower-Income Countries

OCTOBER 2018

**Note 59:** How a Know-Your-Customer Utility Could Increase Access to Financial Services in Emerging Markets

**Note 58:** Competition Works: Driving Microfinance Institutions to Reach Lower-Income People and the Unbanked in Peru

SEPTEMBER 2018

**Note 57:** Blockchain Governance and Regulation as an Enabler for Market Creation in Emerging Markets

JULY 2018

**Note 56:** A Practical Tool to Create Economic Opportunity for Low-Income Communities

JUNE 2018

**Note 55:** Peru's Works for Taxes Scheme: An Innovative Solution to Accelerate Private Provision of Infrastructure Investment

MAY 2018

**Note 54:** Modelo Peru: A Mobile Money Platform Offering Interoperability Towards Financial Inclusion

APRIL 2018

**Note 53:** Crowding-In Capital Attracts Institutional Investors to Emerging Market Infrastructure Through Co-Lending Platforms

**Note 52:** Crowding-In Capital: How Insurance Companies Can Expand Access to Finance

**Note 51:** Blended Finance—A Stepping Stone to Creating Markets

JANUARY 2018

**Note 48:** Increased Regulation and De-risking are Impeding Cross-Border Financing in Emerging Markets

OCTOBER 2017

**Note 47:** From Farm to Fork: Private Enterprise Can Reduce Food Loss Through Climate-Smart Agriculture

**Note 46:** Precision Farming Enables Climate-Smart Agribusiness

SEPTEMBER 2017

**Note 45:** Beyond Fintech: Leveraging Blockchain for More Sustainable and Inclusive Supply Chains

**Note 44:** Blockchain in Financial Services in Emerging Markets—Part II: Selected Regional Developments

**Note 43:** Blockchain in Financial Services in Emerging Markets—Part I: Current Trends

AUGUST 2017

**Note 42:** Digital Financial Services: Challenges and Opportunities for Emerging Market Banks

JULY 2017

**Note 41:** Blockchain in Development—Part II: How It Can Impact Emerging Markets

**Note 40:** Blockchain in Development—Part I: A New Mechanism of 'Trust'?

**Note 39:** Technology-Enabled Supply Chain Finance for Small and Medium Enterprises is a Major Growth Opportunity for Banks

MAY 2017

**Note 38:** Can Blockchain Technology Address De-Risking in Emerging Markets?

APRIL 2017

**Note 37:** Creating Agricultural Markets: How the Ethiopia Commodity Exchange Connects Farmers and Buyers through Partnership and Technology

**Note 35:** Queen Alia International Airport—The Role of IFC in Facilitating Private Investment in a Large Airport Project

MARCH 2017

**Note 34:** How Fintech is Reaching the Poor in Africa and Asia: A Start-Up Perspective

**Note 33:** Creating Markets in Turkey's Power Sector

FEBRUARY 2017

**Note 32:** Private Provision of Education: Opportunities for Emerging Markets

**Note 31:** Improving Emerging Markets Healthcare Through Private Provision

JANUARY 2017

**Note 30:** Masala Bond Program—Nurturing A Local Currency Bond Market

**Note 29:** Toward a Framework for Assessing Private vs. Public Investment in Infrastructure

**Note 28:** The Importance of Local Capital Markets for Financing Development

DECEMBER 2016

**Note 27:** How Banks Can Seize Opportunities in Climate and Green Investment

NOVEMBER 2016

**Note 24:** De-Risking by Banks in Emerging Markets—Effects and Responses for Trade

**Note 23:** Energy Storage—Business Solutions for Emerging Markets

**Note 22:** Mitigating the Effects of De-Risking in Emerging Markets to Preserve Remittance Flows

SEPTEMBER 2016

**Note 20:** Mitigating Private Infrastructure Project Risks

**Note 19:** Creating Mobile Telecom Markets in Africa

**Note 18:** Seven Sisters: Accelerating Solar Power Investments

**Note 16:** Congo Call Center—Business Amid Fragility

**Note 15:** How Emerging Market Leaders Can Spur Technological Gains

**Note 14:** How to Make Infrastructure Climate Resilient

**Note 13:** Insurance Options for Addressing Climate Change

**Note 12:** New Ways for Cities to Tackle Climate Change

**Note 11:** How Business Can Insure Against Climate Risks

**Note 10:** How New Data Tools Can Assess Climate Risks

**Note 9:** Innovative Insurance to Manage Climate Risks

MAY 2016

**Note 6:** Global Productivity Slowdown and The Role of Technology Adoption in Emerging Markets

APRIL 2016

**Note 5:** Infrastructure Financing Trends

**Note 4:** Infrastructure Finance—Colombia and FDN

**Note 3:** Blending Public and Private Finance

**Note 2:** Case Study—Bayport Financial Services

**Note 1:** Supporting Local Bond Market Development



## About IFC and the Distressed Asset Recovery Program

IFC's Distressed Asset Recovery Program (DARP) focuses on the acquisition and resolution of distressed assets, the refinancing and rollover risk of viable entities, and restructurings of small and medium enterprises (SMEs). DARP is a critical and effective tool for reducing the effects of poverty in emerging markets by preventing the loss of assets (mainly family homes and productive assets) and access to formal credit, while helping to preserve jobs. DARP has allowed banks to offload \$30 billion in non-performing loans (NPLs) and is facilitating the normalization of obligations of more than 18 million households and SMEs. At the same time, it is introducing and supporting best resolution practices. Access to finance and credit helps drive economic growth. Yet when banks have unresolved NPLs on their books, the flow of credit stalls, and so does growth. With the growth of credit globally, effective ways of resolving distressed assets is increasingly critical. The ability to quickly dispose of problem assets is even more necessary during financial crises. As distressed assets are cleared from a financial system, economic recovery can pick up pace and lending and job creation can resume. Since 2007, IFC has committed over \$7.3 billion globally through DARP, of which \$2.7 billion comes from IFC's own account and \$4.6 billion from third-party investors. DARP enables IFC to rapidly and successfully introduce non-performing asset resolution capabilities across the markets in which we work. IFC continues to build the infrastructure needed for distressed assets globally, serving as a catalyst for the development of secondary distressed assets markets. Please see our short video on IFC's Distressed Asset Recovery Program here: [https://www.ifc.org/wps/wcm/connect/ Industry\\_EXT\\_Content/IFC\\_External\\_Corporate\\_Site/Industries/Financial+Markets/Retail+Finance/DARP/](https://www.ifc.org/wps/wcm/connect/Industry_EXT_Content/IFC_External_Corporate_Site/Industries/Financial+Markets/Retail+Finance/DARP/).

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