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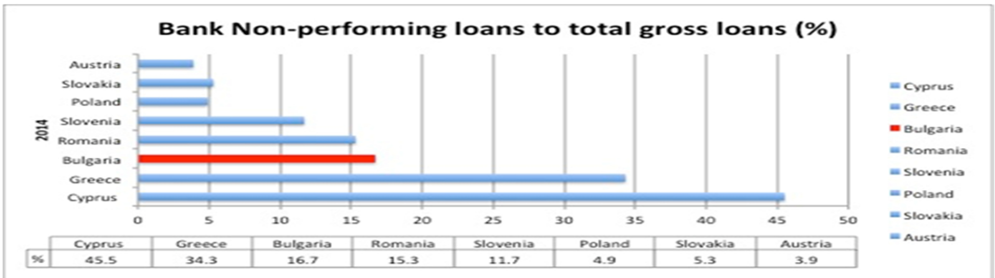
REGULATORY PUSH TO UNLOCK NPL SALES IN BULGARIA

The 2014 collapse of the Corporate Commercial Bank (ranked 4th in the country) raised doubts about the accuracy of the overall liquidity ratio (34.80%) and asset value (approx. EUR 44.07 billion) of the banking sector in Bulgaria, not least because assets had been evaluated according to the internal rules of the respective credit institutions. The implementation of the EU Bank Recovery and Resolution Directive (**BRRD**) alongside the high ratio of non-performing loans (**NPLs**) triggered the Bulgarian National Bank (**BNB**) to push for significant reforms.

HOLD STRATEGY

Despite the high level of NPLs in Bulgaria, above 16% of total gross loans, as assessed by the International Monetary Fund in its Global Financial Stability Report of April 2015, disposals have been slow to start for various reasons, not least the pricing gap between the book and market value of the collaterals. Banks were reluctant to seek effective divestments, preferring to transfer the NPLs to related companies instead of bringing them to the market and suffering losses.



REGULATORY CHANGES

In August 2015, Bulgaria introduced the new European bank resolution regime by transposing the BBRD. This resulted in significant legislative changes enabling early, pre-insolvency intervention on the part of the BNB into the management and operations of a bank when it is threatened by a failure. Consequently, in October 2015 the BNB published a Plan on Reforms and Development of Banking Supervision. It established a Banks Restructuring Department which is empowered to intervene in financial institutions with high risk of destabilization. The BNB has firmly stated the necessity of implementing the 2012 Basel principles and the European Banking Authority's Manual on Common Procedures and Methodologies for the supervisory review and evaluation process in the new regulatory framework.

The first step in executing the reforms was the initiation of the AQR review of Bulgarian banking institutions (22 out of 28 banks operating on the local market). Following the selection of a third-party, external advisor, which was mandated by the adaptation of the ECB methodology, the local banks completed the preparatory stage of the AQR exercise by appointing AQR auditors. The next stages in the AQR process will involve stress test completion in July, AQR review completion in August, and implementation of AQR measures from September onwards.

EXPECTED OUTCOME IN BULGARIA

NPL's tie up bank capital that could otherwise be used to increase lending. They reduce bank profitability, damage external credit ratings and funding costs. Therefore, given similar regulatory reforms, the banks in CEE & SEE have begun actively to deleverage their NPLs, in some cases with government support. The government of the Republic of Slovenia established a Bank Asset Management Company to acquire NPLs after the AQR in Slovenia, thus following Western Europe's pattern of "bad" bank structures. Another example of the government support has been seen in Austria with the establishment of the Heta Asset Resolution (formerly Hypo Alpe-Adria International), which established a new precedent in implementing the new European banking resolution regime. In Romania, the growing burden of the NPL's on banks' balance sheets expedited their disposal.

Government intervention in the banking sector is not new for Bulgaria, where a Banking Consolidation Company operated in the early 90s, although at that time with the pre-defined purpose to facilitate privatization. We anticipate that the developments in Bulgaria will be closer to the Romanian model. The AQR will determine whether the valuation of the reviewed banks' assets is market consistent. This will guide the bid/ask positions to a large extent. As a result, a more vigorous NPL restructuring process will be triggered. Indeed, we have seen the first results in terms of large scale portfolios being brought to the market. We see an increasing appetite from investors and growth in experience with local transaction among the NPL servicers, leading us to expect that the disposals will accelerate in the next few months.

WHAT WILL BE THE EFFICIENT SOLUTION?

Whether the AQR will result in direct sales of NPL's or whether a more complex structure will be required depends on numerous factors. From an investor perspective, one of the key value determinants is the speed with which they can start working with the acquired portfolios. The detection and resolution of legal impediments is therefore an early action in the acquisition process. In our Banking and Finance practice at Wolf Theiss, we have structured loan acquisition vehicles which have been used successfully for NPL transactions. This has proven to be one of the efficient solutions for key distressed assets or NPL portfolio disposals. Notwithstanding certain legislative debt acquisition constraints in Bulgaria, the setup of this kind of company represents a profitable undertaking which provides banks and investors with significant benefits, given the opportunity to improve loan management and to share dividends from the company. Such a structure would further overcome any long and rather inefficient collection and enforcement procedures and may also serve as platform for attracting co-investors for larger portfolios.

In addition, the expected amendment will alter the scope of investment of the REIT companies in Bulgaria such that they can invest in and consequently securitize loans which are subject to judicial dispute. Similar structures led to rapid expansions of NPL portfolios sales in Poland where the banks selling them to securitization funds were additionally incentivized by exemptions from taxation and licensing. Simultaneous legislation changes are continuing, which are intended to prioritize rehabilitation over liquidation in the insolvency process and thus overcome some of the hurdles in voluntarily restructuring. Therefore, as a result of these regulatory improvements, the flexibility of NPL portfolios investment schemes might be enhanced.

For further analyses on the legal aspects of the Loan Portfolio Transactions in CEE/SEE, please refer to: Loan Portfolio Transactions in CEE&SEE.

Sources used: BNB, International Monetary Fund and its Global Financial Stability Report

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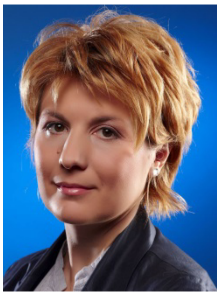

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