Linklaters

Insight and foresight.
Navigating the European loan portfolio market

linklaters.com/europeanbanking

Contents

Executive summary

European banks face increasing pressures to deleverage.

The European Central Bank has identified in its asset quality review non-performing loans totalling over €850bn held by the banks directly supervised by it (box 1). Banks are likely to be encouraged to reduce those exposures and de-risk. Banks are increasingly incentivised to divest loan portfolios as the cost to them of holding regulatory capital-hungry loans rises with Basel 3 regulatory capital and liquidity rules being phased in. Banks' commercial objectives may also drive deleveraging as they potentially seek more generally to de-risk, or even withdraw from the market, in certain sectors, jurisdictions or asset classes.

These conditions present purchasers with a wide range of investment opportunities.

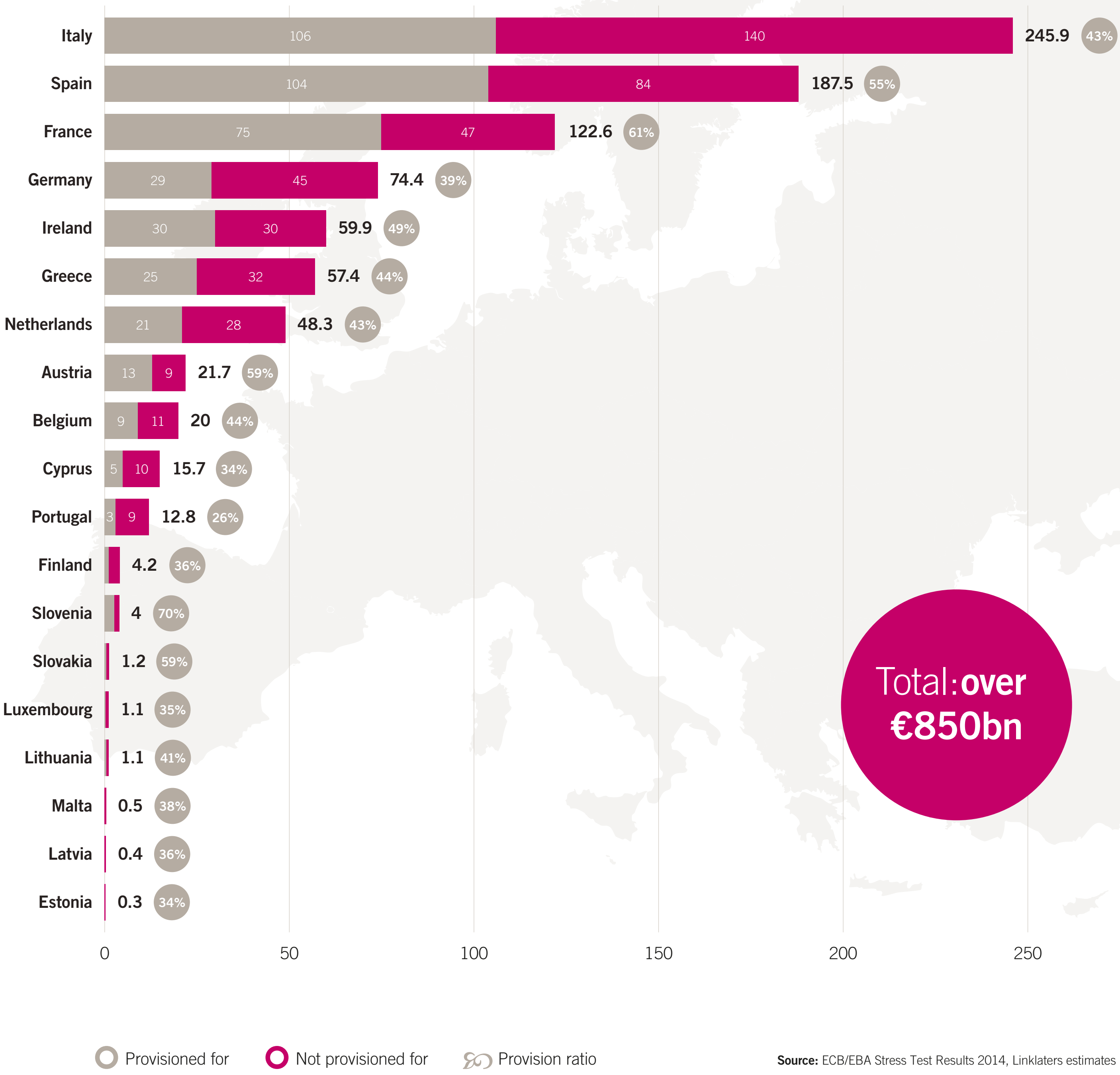
Acquiring a loan portfolio, whether outright or using more complex structures to achieve an economic but not legal transfer of the portfolio, is a key option. Other possibilities may also be considered. Purchasers may seek to partner with sellers, for example together targeting certain loans for work-out. This combines the parties' expertise and assets, and may share funding costs and future upside. Purchasers may seek to access servicing capability as a means of enhancing their operational efficiency and identifying early future loan investment opportunities. They may acquire a servicing platform from a bank or partner with a third party servicer.

A detailed understanding of the market is essential to maximise such opportunities.

Regulatory requirements for the purchaser to hold a licence to lend, loan transfer options and loan/security enforcement strategies should be checked, and documentation with appropriate protections should be negotiated. The position on many of the issues raised varies across Europe. Ongoing Europe-wide legislative reform adds complexity. Legislative/regulatory conditions and commercial techniques which have fostered strong deleveraging in jurisdictions such as Spain and Portugal may be transported cross border and used successfully elsewhere.

Purchasers who are able to navigate the market knowledgeably and analyse each transaction on a jurisdiction by jurisdiction basis will be best placed to invest in European loan portfolios. This report and Linklaters' European Guides to Loan Portfolio Transactions aim to highlight key considerations for today's market participant and outline successful techniques for deal structuring and execution.

Box 1: European Central Bank estimated non-performing loans by bank jurisdiction, €m



Source: ECB/EBA Stress Test Results 2014, Linklaters estimates

1. Key structuring/ execution issues

The issues shaping the transfer of a loan portfolio will vary depending on a transaction's commercial requirements and the nature of the loan assets. Some points, however, are fundamental and will always require analysis. These are discussed in this paragraph 1.

1.1 Acquisition structures

Outright sale

Various factors will drive the choice of structure to transfer the loan portfolio. Outright sale is typically considered first. This allows the seller to move the loans off its balance sheet and may be preferred if the seller wishes fully to exit regulatory capital-hungry business areas or non-core jurisdictions/sectors. Outright sale may not, however, always be appropriate or possible. It may not be tax efficient for the purchaser, for example if secured loans attract significant transfer taxes, or contractual transfer restrictions affecting the loan portfolio may limit, or even remove, the availability of this structure.

Other common structures

Alternative techniques may be more suitable. Options commonly considered include hiving-down the loan portfolio to a SPV within the seller's group and selling the SPV shares to the purchaser, sub-participating the loan portfolio to the purchaser or transferring the loan portfolio using a statutory transfer scheme.

Hive-down and share sale typically does not require borrower consents to transfer under contractual transfer restrictions, but may trigger change of control provisions in relation to the seller. Tax implications may include stamp duty being payable on the share sale and carry-forward of tax losses being impacted.

Sub-participation also typically circumvents any need to obtain borrower consents to transfer under contractual transfer restrictions, with the seller remaining in place as lender of record and entering into a back-to-back funded or risk sub-participation with the purchaser. Documentary protections for the purchaser's position should be analysed. These may include loan voting rights to address the purchaser's lack of directly enforceable rights against the borrowers and mechanisms to protect the purchaser's credit risk on other entities in the structure. This can be contentious, particularly if the seller has a wider relationship with the borrowers.

Some jurisdictions, such as England and Italy, have statutory frameworks permitting the transfer of a loan portfolio in certain circumstances. This typically brings advantages of speed, legal certainty and cost savings (sometimes avoiding expensive stamp duty) and may avoid the need to seek borrower consents to transfer. In light of these advantages, it is important to check if any such mechanism is available and appropriate, although in practice the legislative conditions attached to such schemes, such as in England needing to include a deposit-taking business, mean they are of limited suitability in this context.

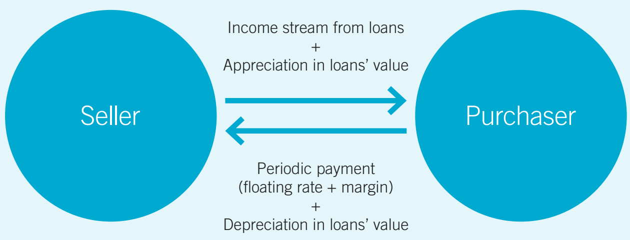
Synthetic structures

Synthetic structures, including total return swaps, credit default swaps, loan repackagings or declarations of trust, offer other alternatives and potential benefits.

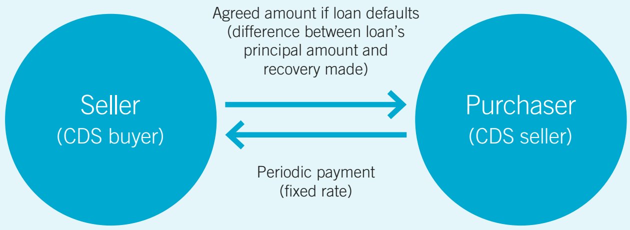
A total return swap transfers the economic performance of the loan portfolio as illustrated in box 2. The purchaser does not purchase the loan portfolio upfront and so, subject to the level of collateral required, effectively obtains a leveraged position in the loans. Collateral will be a key issue for both parties given their reliance on the other's creditworthiness for performance of the swap. The floating rate payable on the swap may be more attractive than borrowing capital to purchase the loans outright. As with a sub-participation, the purchaser's loan voting rights should be protected as it bears the loans' economic risk and reward.

A credit default swap transfers risk in the loan portfolio as illustrated in box 3. This may be used for identified loans or, increasingly, blind pools of loans which are unidentified but meet agreed eligibility criteria. This maintains the seller's confidentiality in relation to the loans and enables the purchaser to acquire exposure to particular sectors, jurisdictions and classes of borrower. An independent verification agent is essential to verify that a defaulted loan formed part of the portfolio at the time of default and the amount of any recoveries. The process required to maximise such recoveries should be agreed. Protection may be sold over only a tranche of the risk, requiring the purchaser to maintain an agreed amount of unhedged exposure and so aligning the parties' interests. The purchaser will typically require collateral from the seller to support its payment obligation.

Box 2: Total return swap



Box 3: Credit default swap



> Swap-based and other synthetic structures offer many benefits, typically circumventing contractual transfer restrictions and potentially enhancing the purchaser's financial return.

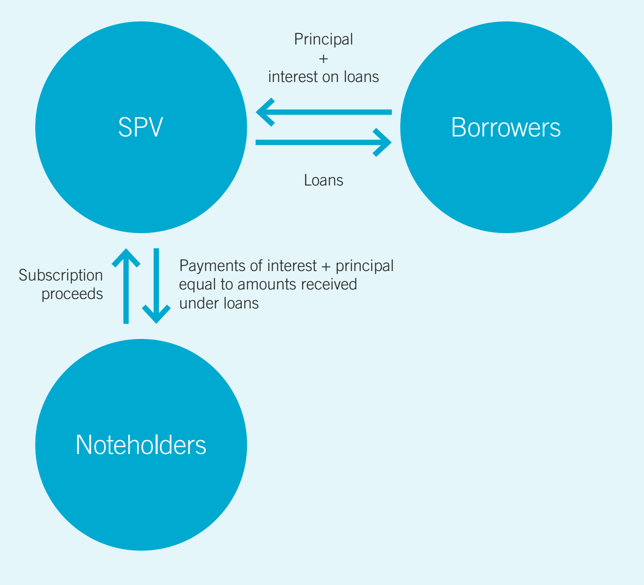
Matthew Monahan
Partner – Capital Markets
Linklaters – UK

A loan repackaging may assist where contractual transfer restrictions prohibit transfer to the purchaser but allow transfer to a SPV, or where the purchaser is not able to enter into a loan but may hold notes, as illustrated in box 4. It also allows investors to hold an instrument capable of rapid transfer, compared to a typical loan, through clearing systems. This is particularly useful if the investors wish to use that instrument as collateral for another transaction.

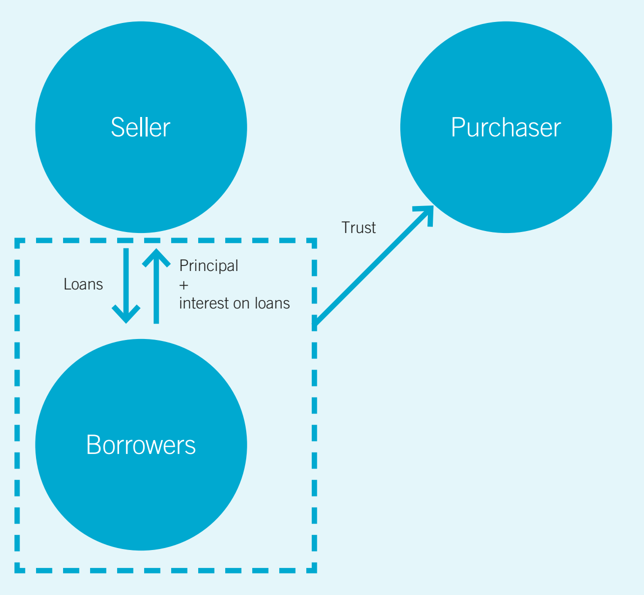
A declaration of trust may assist where outright sale is not possible, provided the relevant jurisdictions recognise the concept of a trust. It allows the loans to remain with the seller, who declares a trust over them in favour of the purchaser, as illustrated in box 5. This requires careful analysis of the seller's freedom to declare the trust without breaching either contractual restrictions in relation to the loans or widely-drafted negative pledges. The purchaser should be aware that, while this structure allows assets to be isolated from the general insolvent estate of the seller, if the seller has other liabilities, assets and creditors, its insolvency can mean a delay in recovering trust assets and a potential reduction in the amount of available trust assets to the extent they can be used to satisfy trustee liabilities.

Finally, more structured alternatives could be adopted. For example, we have worked on CLO-based structures, such as static pool true sale CLOs and managed CLOs, and covered bonds.

Box 4: Loan repackaging



Box 5: Declaration of trust



> Recent changes in Italian law on lending licence requirements will help to open the Italian loan portfolio market to international investors.

Francesco Faldi
Partner – Banking and Projects
Linklaters – Italy

1.2

Structuring issues

Bid vehicle

The bid vehicle will typically be structured as an insolvency-remote SPV, established in a tax efficient manner. It may be in the purchaser's group or an orphan. This choice will depend on tax considerations and concerns as to liabilities which the SPV might inherit.

The tax analysis done when the loans were originally entered into will need to be re-done in relation to the purchaser to determine whether withholding tax will be imposed on interest payments to the purchaser, the availability of the tax gross-up and any contractual limits to this, such as requiring the tax gross-up beneficiary to be tax-resident in a particular jurisdiction. Each of these features may impact the choice of jurisdiction of incorporation of the bid vehicle.

Regulatory requirements

Some jurisdictions require an entity to have a licence to lend in order to make advances under loan facilities. Jurisdiction-specific requirements are highlighted in Linklaters' European Guide to Loan Portfolio Transactions: Licences to Lend and Transfer of Security Agent/ Security Interests. These are subject to change as a result of legislative reform in certain jurisdictions, with Italy witnessing recent changes to relax its licensing regime and potentially set to see more as outlined in box 6.

Box 6: Italy: new rules on licences to lend

- Italian legislation introduced in June 2014 relaxed the requirements to obtain licences to lend in Italy.
- Italian securitisation SPVs and insurance companies are now permitted to make loans to Italian borrowers without a licence to lend, subject to complying with certain conditions. For example, the borrower must not be an individual or a micro-enterprise, the borrowers must be selected by a duly licensed bank and the "selecting bank" must retain a 5% interest in the loan.
- This legislation also broadly contemplates the possibility that credit funds may be permitted to make loans to Italian borrowers without a licence to lend. This will not be possible in practice until the Bank of Italy adopts the relevant implementing regulations.
- If the purchase concerns a single loan, as opposed to a portfolio with multiple loans, it is possible to argue that a European collective investment scheme may acquire the loan without a licence to lend.
- If the purchase concerns non-performing loans which have been accelerated, it is unlikely that the purchaser will require a licence to lend, although this is currently subject to consultation by the Bank of Italy and the Italian Treasury. However, if the purchaser does not have a licence to lend, it will be unable to agree restructuring/ rescheduling arrangements with the borrowers. If the purchaser wishes to collect debts in relation to those loans, it must register with the relevant government authority.

If the purchaser already holds a licence to lend in a European jurisdiction, it may be possible to passport that licence into another European jurisdiction. If so, the impact of any future changes to the local regulatory framework, particularly in light of significant ongoing reform in the European banking landscape, should be considered. We have seen situations where this results in loss of the passported licence.

If the purchaser is acquiring consumer loans, additional licences or authorisations may be required. Unsecured consumer lending is likely to require the purchaser or, with appropriate structuring, the “creditor” only (who may be a third party) to hold data protection, consumer credit and/or payment services licences/authorisations. First ranking residential mortgage lending may also require the purchaser or, with appropriate structuring, third parties holding legal title to/administering the loans, to be duly authorised by the local regulator. Requirements vary across Europe and the process for obtaining such licences and authorisations may be lengthy.

If the loans are secured, there may be regulatory requirements in relation to the types of entity permitted to hold security. For example, in Italy certain types of security (such as *privilegio speciale*, a special lien granted over certain movable assets) may only be held by Italian banks, EU banks or non-EU banks which are licensed in Italy, and in Portugal certain security arrangements (including some types of pledges of assets or shares) may only be held by financial institutions. Jurisdiction-specific requirements are highlighted in Linklaters’ European Guide to Loan Portfolio Transactions: Licences to Lend and Transfer of Security Agent/Security Interests.

Bank secrecy/confidentiality rules on disclosing information about customers may prevent the transfer to the purchaser of key information about the loans or the borrowers. Breach of such rules carries criminal sanctions in some jurisdictions, making it important to identify their application early. Contractual confidentiality provisions should also be checked as they too may restrict the flow of this information to the purchaser. Data protection legislation in most European jurisdictions requires the purchaser to comply with an additional set of formalities in relation to certain information about individuals, and potentially limited partnerships and companies. The scope of any such legislation should be identified early.

Co-investment/seller support

The purchaser may agree to partner with the seller in some circumstances. They may form a joint venture to house and then work-out the loans, or may enter into servicing arrangements in relation to the loans as outlined in box 7.

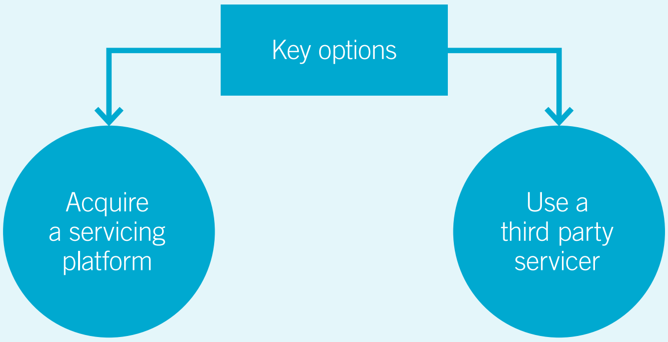
In some circumstances the purchaser may offer the seller the option to retain a minority interest in the loans as a way of improving its bid. This may be attractive if the seller plans to continue its presence in the market or to retain upside on work-out loans. If so, it will impact the structure of the transaction, with the purchaser typically having first receipt of any proceeds from the loans plus an agreed return on its original investment, followed by the seller.

The seller may give the purchaser support, temporarily or on a more permanent basis, in managing the loan portfolio post-transfer. For example, there has been a recent trend of sellers seconding to the purchaser’s business employees who can later be redeployed back to the seller after a transitional period.

"A purchaser's ability to access appropriate loan servicing capability is a key component of success in acquiring a loan portfolio in Spain."

Victor Manchado
Partner – Corporate
Linklaters – Spain

Box 7: Loan servicing arrangements



Acquire a servicing platform

Structure

- Purchaser may acquire a servicing platform from seller, alongside loan portfolio. Parties may simultaneously enter into a long-term servicing contract.

Opportunities

- May exist where banks have not already sold their servicing platforms. In more mature markets where sales of servicing platforms have already taken place, e.g. Spain/ Portugal, opportunities for more sales may also be possible.

Key points

- Gives purchaser potential first view of loans subject to future sale. This may be de facto or via contractual agreement with the seller.
- Gives purchaser improved (and proprietary) due diligence capability.
- Allows purchaser to strengthen its relationship with the seller.
- Regulatory approvals for acquisition may be required if the servicing platform is owned by a regulated affiliate of the seller.

Use a third party servicer

Structure

- Purchaser may use a third party servicer and potentially partner with it during due diligence.

Opportunities

- May exist widely, with servicers in all major jurisdictions.

Key points

- Gives purchaser improved due diligence capability (in particular if has no/limited experience in the relevant market/asset class).
- Level of servicer's experience is key to accessing most effective capability. May be difficult to use most experienced servicers in relatively small servicer market.
- Timing/cost implications of agreeing appropriate arrangements with servicer where no existing relationship with purchaser.

Hedging

The loans may be hedged by an interest rate and/or currency swap. If the swap is economically tied to the loan, the seller is unlikely to wish to keep the swap once the loan has been transferred. Contractual provisions may staple the swap to the loan, preventing the loan from being transferred without the swap.

If the purchaser is willing and able to acquire the swap, the swap counterparty's consent to transfer is likely to be required. The transaction structure should accommodate scenarios in which this may not be obtained, to give the seller and the purchaser the flexibility they need. For example, the seller may retain a minimal participation in the loan if this is contractually permitted. It may also be necessary to include multiple purchaser entities in the structure if the purchaser wishes to hold the loans and the swaps separately and this is contractually permitted.

If the purchaser wants to acquire the swap, it should consider whether it must comply with any licensing/authorisation requirements and the impact of EMIR. This requires, at a minimum, parties to a swap periodically to reconcile their positions under the swap and to document specified dispute resolution procedures to settle any disputes which might arise as a result of that reconciliation process. The parties are also required to report to a trade repository specified data in respect of the swap transaction. This may be reported directly or through a delegate.

1.3

Due diligence

Key purposes

Due diligence is a key early area of focus for the purchaser, allowing it to understand the loan assets more fully and to assess features which will impact the transaction's structure. It also forms the purchaser's knowledge base for modelling purposes and enables it to identify where to seek contractual protections from the seller. A valuable tool, but also potentially a costly one, the key question for the purchaser is how much due diligence it should do and when.

Data tape and vendor due diligence

The starting point is the seller's data tape containing key information about the loans, such as the amounts outstanding, undrawn commitments and interest rate. This will be the basis of the purchaser's valuation of the loans. Appropriate protection addressing key fields in the data tape should be provided in the transaction documentation, as discussed in paragraph 1.5 below.

The extent to which vendor due diligence is provided varies. It can offer significant advantages for both the seller and the purchaser, for example potentially reducing the transaction's timetable and facilitating agreement of the purchase price by identifying early any issues in the loan portfolio. Without this clarity, the purchaser may wish to scrutinise the loan assets more closely, so impacting timing and potentially unearthing more issues. The warranties negotiation may be simplified if the seller has been able to identify those it may give without risk, and the purchaser can focus on those of key concern to it. There is, however, a cost to the seller in doing this work and in practice the amount of vendor due diligence provided to the purchaser may be limited. As the market appears ever more attractive for sellers, the level of vendor due diligence has reduced.

Purchaser due diligence

The purchaser is likely to engage in its own more detailed due diligence once the full data room is open. The level of due diligence conducted by the purchaser will be driven by the amount of vendor due diligence, the purchaser's risk appetite and level of comfort with the transaction. Due diligence on unsecured loans is typically less extensive than that on secured loans where advisors will need to assess the issues discussed in paragraph 1.4 below so any relevant points can be reflected in the purchaser's pricing model. Particular points will also need to be checked depending on the nature of the underlying loan asset, as box 8 highlights in relation to commercial real estate, consumer and shipping loans.

> The purchaser must decide early the scope of its due diligence. Vendor due diligence may be limited, making it more important for the purchaser to conduct its own review and determine what is possible in the time available and where the most sensitive areas are likely to be, so that due diligence is targeted, efficient and produces a useful output.

Andrew Vickery
Partner – Capital Markets
Linklaters – UK

Box 8: Due diligence: asset specific issues

Commercial real estate loans

- ✔ Check title and mortgage information to establish security position.
- ✔ Conduct searches of public registers, for example land registries, to obtain information about secured real estate.
- ✔ Determine extent of cross guarantees and cross collateralisation within lending structures.
- ✔ Identify ongoing funding/liquidity requirements to be satisfied by the purchaser.
- ✔ Obtain valuations of the real estate.

Consumer loans

- ✔ Check relevant documentation exists and customer consents may be evidenced in court.
- ✔ Identify any provisions in the underlying agreements which may be unenforceable or breach consumer lending codes/guidelines.
- ✔ Identify any provisions requiring amendment or practices to be stopped in future, to avoid regulatory intervention/negative publicity.
- ✔ Consider limited sampling of agreements and reviewing standard contract templates.
- ✔ Identify any regulatory or origination breaches, such as mis-selling issues or inconsistencies between contract terms and marketing materials.
- ✔ Identify ongoing funding/liquidity requirements to be satisfied by the purchaser.

Shipping loans

- ✔ Obtain third party expert valuations of the vessels, typically on a desktop basis.
- ✔ Obtain industry expert report on insurances in place for the vessels.
- ✔ Consider whether purchaser or seller, with appropriate reliance for purchaser, should commission these reports.
- ✔ In distressed cases or if circumstances otherwise warrant, consider physical inspection of the vessels.
- ✔ Consider borrower jurisdictions and vessel flag states as these may heighten lender liability risks (e.g. sanctions breaches) or complicate any enforcement process in relation to the loan assets.

> On a cross-border transaction, a network of European laws will determine key security points – from issues affecting valuation of the portfolio to security enforcement options.

Nuno Ferreira Lousa
Partner – Dispute Resolution
Linklaters – Portugal

1.4

Security issues

If any loan to be transferred is secured, it is important to identify whether the security has been created effectively, how it may be transferred and what enforcement options are available in relation to the secured assets (with a particular focus on time and cost implications). This will impact the purchaser's valuation of the loans, and so its model and pricing of the loan portfolio. The starting point for these questions is to identify the assets secured, their location and the governing law of the relevant security documents.

Creation of security

Various issues may impact the creation of effective security, from those which can be addressed with relative ease, subject to timing and cost implications, to those which may result in the security being defective.

Most commonly, original documents may be missing. In England this presents few problems as copy documents generally suffice. Real difficulties may, however, arise in many European jurisdictions, for example where seeking to enforce German land charges. Where documents are available, certain formalities or documentary requirements may not have been satisfied, resulting in the security being wholly defective or certain enforcement rights being unavailable (for example, the power of sale under an English mortgage, if not documented by way of deed). It is important to consider in these circumstances what other rights remain available to the security holder. For example, if an English law security agreement includes a floating charge over the chargor's assets, the security holder may still be able to appoint an administrator and recover its monies. Various jurisdictions require specific wording to be used in security documents, the absence of which may be problematic where new, equivalent, security cannot be taken.

Where security registrations have not been made, the effect will depend on whether those registrations were required within a specified period after creation, the absence of which attracts consequences such as the security being void as against a liquidator or administrator, or may be made subsequently, prior to enforcement steps being taken.

Transfer of security

The identity and nature of the secured assets will determine the necessary steps to perfect a transfer of security over those assets. These steps vary depending on the type of asset secured and may include making supplementary registrations at land/other registries and delivering supplementary documents to the purchaser.

How the security is held will determine the transfer mechanics for the security. If it is held by a security trustee/agent, the transfer is likely only to need to comply with the contractual transfer mechanics in the facility agreements and no other formalities, unless the role of the security trustee/agent itself is to be transferred. In this case the security property must be transferred to the replacement security trustee/agent and any necessary formalities and perfection requirements must be satisfied. This will be done separately from the transfer of the loans.

If the security is held directly by the seller, for example because the loan is bilateral or, as is typical in some European jurisdictions, the security has otherwise been granted direct to the individual lenders, the security rights themselves will need to be transferred (which may be expensive and in some cases require full registration) or fresh security taken (which may require the borrower's consent and re-start any insolvency hardening periods). It may also be necessary to check if the loan is to be novated that this will not result in the loan becoming unsecured, which could occur in some European jurisdictions.

Jurisdiction-specific requirements in relation to these issues are highlighted in Linklaters' European Guide to Loan Portfolio Transactions: Licences to Lend and Transfer of Security Agent/Security Interests.

Security enforcement

Strategies to enforce security will be a question for the purchaser on any loan portfolio including secured assets, and a key question where the purchaser's underlying commercial purpose is "loan to own". It will need first to understand the enforcement options available in relation to different types of asset. These may range from a relatively simple private sale or appropriation of the relevant asset, through to a more complex and time-consuming public auction or court process. Each method has timing and cost implications which should be analysed carefully as this too will impact the purchaser's valuation of the loans, and so its model and pricing of the loan portfolio. Jurisdiction-specific requirements are highlighted in Linklaters' European Guide to Loan Portfolio Transactions: Enforcing Security.

> Agreeing appropriate warranty/indemnity protection for the purchaser is essential, with particular focus on the data tape content and redress for issues identified in the due diligence process such as regulatory or mis-selling issues.

Tracey Lochhead
Partner – Corporate
Linklaters – UK

1.5

Negotiating hotspots

Scope of assets/liabilities

It is important to describe clearly in the sale and purchase agreement the scope of the loan assets and related assets/liabilities to be transferred. The assets are typically defined by reference to the data tape prepared by the seller. Any liabilities which the purchaser does not agree to assume should be expressly excluded from the transaction. It is common practice for all liabilities prior to the transfer to remain with the seller. If the purchase price is based on the information provided in the data tape, the reference date for dividing the liabilities will typically be the date of the data tape.

Contractual protections

Given the importance of the data tape, the sale and purchase agreement should include sufficient protection to the extent that the data tape is incorrect/incomplete or the wrong loans are transferred to the purchaser. This is typically achieved via a price adjustment or an indemnity from the seller. If the seller has a particular sensitivity on indemnities, super-warranty protection with few limitations on the seller's liability (100% purchase price cap, unlimited time limitation, no de minimis threshold or basket) may be an alternative approach. The level of cover varies considerably between asset classes and the bargaining position of the parties. This is perhaps the most important contractual protection from the purchaser's perspective.

Other indemnities which the purchaser may wish to include address incomplete/missing loan documentation which prevents enforcement of the loans, any losses/liabilities incurred by the purchaser in relation to the excluded liabilities and liabilities/contingencies discovered during the due diligence process including regulatory or mis-selling issues.

In relation to secured loans, it may be preferable to give the purchaser the option under the sale and purchase agreement either to require the seller to pay damages or to replace the loan with another loan of similar characteristics if there are any enforcement issues or defects in the underlying security.

Timing

It is common for there to be a gap between signing and closing so that, to the extent applicable, any regulatory authorisations, third party consents and anti-trust/state aid approvals are obtained. In addition, where the portfolio includes secured loans the sale and purchase agreement may provide for a short period following signing during which the purchaser is able to verify and exclude or substitute any loans not complying with the agreed criteria.

The purchaser will need to consider the practical implications of acquiring the loans and whether it has the correct IT infrastructure and personnel (or has contracted a third party servicer) to on-board the loans. If not, the purchaser will need sufficient time to set up the relevant IT platform before migrating the loans. The seller may be required to assist the purchaser in the migration process. This is typically documented in a separate transitional services agreement.

It is important to ensure post-closing that all loan documentation is delivered to the purchaser. This is particularly relevant for jurisdictions such as Spain where the lack of original documentation may hinder the purchaser's ability to enforce the loans in court or pose significant delays to the enforcement process.

2. Key financing issues

Certain key commercial issues frame the financing for the acquisition of the loan portfolio and should be analysed carefully.

The parties must select their preferred sources of funding, taking into account timing constraints and the impact of any regulatory requirements. The intended exit should be identified at the outset, and any need to refinance in the future should be addressed appropriately.

Flexibility will be crucial for both the purchaser and the funders. The purchaser will wish to retain flexibility to run its business with minimal lender control, balancing this against the restrictions which the lenders will require to protect their position. The lenders will want the flexibility to sell the financing as they consider appropriate in the market, potentially using rights to tranche, splitting the financing into loans and bonds or exercising market flex rights.

2.1 Financing structures

Three key options

A purchaser wishing to arrange funding for its purchase of a loan portfolio is likely to consider three main options – bank loan facility, securitisation and/or vendor finance. Each will be used alongside equity provided by the purchaser's ultimate parent. The funding option selected will shape the structure of the financing, which in turn will need to accommodate any applicable legal or commercial requirements.

Bank loan facility

Bank lenders are likely to want the loan portfolio to be ring-fenced in a separate SPV to which they will lend directly. As discussed in paragraph 1.2 above, the SPV will typically be structured as an insolvency-remote vehicle, established in a tax efficient manner. The SPV structure also facilitates the granting of security back to the lenders, as the SPV may itself provide all relevant security. The loan facility will typically be sized as a percentage of the purchase price for the portfolio and the maximum loan to value based on a market valuation of the portfolio. With that percentage often set between 65% and 70%, the remainder of the funding must be sourced elsewhere, typically from equity, subordinated debt or mezzanine finance.

A loan facility is often used as an outright funding tool but offers the flexibility for use as a bridge to a bond issue or securitisation financing. It can be put in place more quickly than a bond issue and provides a temporary financing structure while the purchaser increases its knowledge of the loan portfolio and identifies issues potentially affecting the transaction. While the purchaser is likely to wish the terms of any such loan facility to be as flexible as those of the ultimate bond issue, the lenders are likely to resist and this will be a key feature of negotiating the loan facility. Less commonly, a loan facility may be used to refinance an acquisition made purely with equity.

Securitisation

A securitisation will also use a SPV-based structure. The loan portfolio will be transferred into a separate SPV which issues notes to investors and the SPV will provide all relevant security to the investors. In contrast to the size of the loan facility as a proportion of the purchase price for the portfolio and the maximum loan to value, the securitisation typically achieves greater leverage than a loan facility. This may mean significantly less funding from other sources is required and is a key factor in the appeal to a purchaser of using a securitisation to fund the purchase.

Another element of a securitisation's appeal is the higher level of flexibility it offers a purchaser in running its business. With a wide pool of institutional investors participating in the securitisation, the controls imposed upon the SPV's business plan and how it runs its business are typically lighter than those imposed under a loan facility where a comparatively smaller bank group is likely to wish to retain more control.

Vendor finance

Vendor finance may be provided through the seller retaining equity in the business, discounting the purchase price or providing a loan to the purchaser. The vendor loan option is used most often and will typically be lent high in the SPV's group structure, distanced from the SPV holding the loan portfolio. This preserves the security granted by the SPV by ensuring there is not a direct seller claim against the SPV, potentially in competition with the bank lenders' or securitisation investors' claims. This structure also assists in ensuring the most favourable regulatory capital and accounting treatment.

The suitability of these options will depend primarily on commercial factors. However, the risk retention rules in the Capital Requirements Regulation ("**CRR**") may also influence the parties' choice, as discussed in box 9 below. For example, the seller may retain an interest in the portfolio or the purchase price for the portfolio may be discounted in compliance with these rules and to achieve the parties' commercial objectives.

2.2

Negotiating hotspots

Due diligence

The lenders' starting point will be the required level of due diligence in relation to the loan portfolio. The purchaser's due diligence, upon which it will expect to rely, is likely to be its main source of information given the likely in-depth remit of this exercise. In some circumstances the lender may also seek to rely on the vendor due diligence, supported by warranties from the seller in the purchase agreement.

Whilst the lenders will look primarily to the due diligence in forming their credit decision, they will also seek comfort from the scope of the seller's warranties in relation to the portfolio. This will vary depending on the transaction. For example, if administrators are selling the portfolio, they are likely to provide very limited warranties, possibly only as to the data tape content and their capacity/authority to enter into the agreement transferring the loan portfolio. More broadly, the seller will be disincentivised from making extensive representations and is likely to resist warranties solely for the lenders.

Level of lenders' control

A thread of tension likely to run through the financing negotiations is the lenders' desire for control in relation to the loan portfolio pitted against the purchaser's wish to operate its business freely and as it considers best. This tension will manifest itself in various ways. For example, in relation to a real estate portfolio, the lenders may wish property disposal proceeds to be fully prepaid against the loan, whereas the purchaser may for example wish to retain flexibility to reinvest those proceeds. The key issue is to agree the parameters for the purchaser to take action in relation to areas such as forbearance and extensions, planning applications, leasing strategy, the negative pledge, adjustments to allocated loan amounts in the portfolio and the level of control over defaults in the loan portfolio. This will achieve an appropriate level of flexibility.

Security

The security package provided to the lenders will be comprehensive, covering all rights of the SPV purchaser. This will typically include all the SPV's rights under the loan portfolio, hedging and underlying security documents in addition to assignments of potential claims in relation to insurance proceeds, report claims, loan servicers and property managers.

CRR risk retention rules

If the transaction constitutes a "securitisation" for the purposes of the CRR, it may need to be structured to comply with the CRR risk retention rules. These are outlined in box 9. It is essential for the lenders and the purchaser to address this issue from the outset, particularly given that failure to comply with these retention (or "skin-in-the-game") requirements will limit which members of the lenders' groups can provide the initial finance and who can invest in the secondary market, so potentially affecting liquidity.

It is key to a successful financing to strike an appropriate balance between the purchaser's wish for flexibility in running its business and the lenders' requirements for controls to protect their position.

Narayan Iyer
Partner – Banking
Linklaters – UK

Box 9: EU risk retention rules and loan portfolio sales: key points

To whom do the CRR risk retention rules apply?

EU-regulated credit institutions and investment firms. Similar rules apply to EU-regulated hedge fund/private equity fund managers under AIFMD and will apply to insurance/reinsurance undertakings under Solvency 2.

Do the CRR risk retention rules apply to loan portfolio sales?

Yes, if the sale is classified as a "securitisation" for CRR purposes. This hinges on factors including whether the purchaser funds itself with tranched financing and whether any funder is an EU-regulated credit institution/investment firm.

What is the main implication if these rules apply?

An EU-regulated credit institution/investment firm may only provide debt finance to the transaction if the "originator, sponsor or original lender" undertakes to retain a minimum 5% "material net economic interest" for the transaction's life using one of five permitted methods.

Who can give the retention undertaking on a loan portfolio sale?

Seller will qualify as "original lender" or "originator" of the loans, but is unlikely to be willing to retain an interest in the portfolio or give a retention undertaking. A non-EU-regulated junior funder is unlikely to qualify as "original lender" or "originator" of the loans, or as "sponsor" if it is not a credit institution/investment firm, and so is unlikely to be able to give a retention undertaking.

What solutions are available if a retention undertaking cannot be given?

Various solutions may be possible but will require careful analysis as to their availability and suitability in each situation.

> Use only non-EU-regulated funders: if the funders to the purchaser are not EU-regulated credit institutions/investment firms, the CRR risk retention rules will not apply. Funders may use a non-EU group member to achieve this. This will impact secondary market liquidity by preventing subsequent transfers to EU-regulated funders.

> Structure transaction not to classify as a "securitisation": local regulators will determine whether a transaction classifies as a "securitisation", and their approaches may vary. Certain structural features may, however, assist an investor in considering how the relevant local regulator is likely to view the transaction for the purposes of CRR. The preferred, though often impractical, solution is to replace junior debt with equity, so only a single bank loan is made. This structure may not constitute tranched financing and so the CRR risk retention rules may not apply.

> Sell portfolio at a discount: 5% discount in purchase price, matched by funding for discounted amount, may constitute retention undertaking by seller.

> Use a double sale structure: a two-step sale, initially to a new SPV which becomes an "originator" and then to the ultimate purchaser, creates a new entity which can give a retention undertaking. This may be successful if the new SPV is connected closely to the funder, but the structure will require careful analysis.

3. Our experience

We have acted on numerous market-leading deleveraging transactions across Europe for purchasers, co-investors, sellers and financiers.

Market-leading expertise

We have extensive experience advising on bank deleveraging transactions, including pre-sale restructurings, portfolio disposals and asset transfers. Our experience includes advising sellers and purchasers, and we are familiar with the legal, commercial and process issues on both sides of the table. We regularly advise on complex transactions, from corporate sales/disposals of banking books or businesses and asset transfers with complex tax and other structuring features to a variety of synthetic transactions including securitisations, swap-based structures and CLOs, and more straight-forward sale and purchase transactions, using either Loan Market Association or bespoke documentation.

Experience across asset classes

We have advised on numerous portfolio transfers across asset classes, including real estate loans, corporate loans, leveraged loans, project finance assets, asset finance loans and leases and consumer loans and mortgages. We are able to draw on Linklaters' expertise in these areas to address any product-specific issues and requirements.

Management/restructuring of loan portfolios

We have advised on complex solutions for the management and/or restructuring of loan portfolios, whether for balance sheet management, regulatory capital, access to government liquidity schemes, restructuring purposes or otherwise.

Cross-border, multi-disciplinary practice

We offer our clients a global service, both in outlook and in reach. Our network of 29 offices is reinforced by an integrated alliance with Allens, the leading Australian law firm with offices throughout Asia, our collaborative alliance with Webber Wentzel, South Africa's premier full-service law firm, and our best-friend relationship with Talwar, Thakore & Associates (TT&A), a leading Indian law firm. In regions where we or they do not have an office and may not practise local law, we have strong relationships across various local law firms.

We are at the forefront of regulatory developments across Europe, Asia and the US as national and regional regulators continue to reshape the banking landscape and respond to the financial crisis. Our tax practice has a strong and long-standing reputation in the market, with strong technical expertise and commercial acumen. We have extensive experience of advising on anti-trust/state aid issues, including bank restructurings and recapitalisations.

Key contacts

Belgium

David Ballegeer
Partner – Banking and Capital Markets
Tel: (+32) 2501 9593
Mob: (+32) 478 904 862
david.ballegeer@linklaters.com

Etienne Dessy
Counsel – Banking and Capital Markets
Tel: (+32) 2501 9069
Mob: (+32) 478 401 597
etienne.dessy@linklaters.com

Stefaan Loosveld
Partner – Dispute Resolution
Tel: (+32) 2501 9521
Mob: (+32) 478 980 944
stefaan.loosveld@linklaters.com

France

Cyril Abtan
Partner – Banking and Projects
Tel: (+33) 1 56 43 57 71
Mob: (+33) 6 2339 2820
cyril.abtan@linklaters.com

Alain Garnier
Partner – Corporate
Tel: (+33) 1 56 43 57 02
Mob: (+33) 6 1085 0837
alain.garnier@linklaters.com

Marc Perrone
Partner – Financial Regulation Group
Tel: (+33) 1 56 43 58 67
Mob: (+33) 6 2352 3160
marc.perrone@linklaters.com

Germany

Kurt Dittrich
Partner – Capital Markets
Tel: (+49) 697 1003 585
Mob: (+49) 172 653 2653
kurt.dittrich@linklaters.com

Michaela Sopp
Partner – Banking
Tel: (+49) 697 1003 294
Mob: (+49) 173 315 8749
michaela.sopp@linklaters.com

Marc Trinkaus
Partner – Banking
Tel: (+49) 697 1003 353
Mob: (+49) 173 666 6162
marc.trinkaus@linklaters.com

Italy

Andrea Arosio
Managing Partner – Italy
Tel: (+39) 028 8393 5218
Mob: (+39) 335 7730 606
andrea.arosio@linklaters.com

Francesco Faldi
Partner – Banking and Projects
Tel: (+39) 028 8393 5242
Mob: (+39) 348 3916 578
francesco.faldi@linklaters.com

Dario Longo
Partner – Capital Markets
Tel: (+39) 028 8393 5219
Mob: (+39) 335 7308 091
dario.longo@linklaters.com

Davide Mencacci
Partner – Banking and Projects
Tel: (+39) 028 8393 5220
Mob: (+39) 340 3231 569
davide.mencacci@linklaters.com

Luxembourg

Patrick Geortay
Partner – Capital Markets and Banking
Tel: (+352) 2608 8232
Mob: (+352) 691 108232
patrick.geortay@linklaters.com

Nicki Kayser
Partner – Capital Markets and Banking
Tel: (+352) 2608 8235
Mob: (+352) 691 108235
nicki.kayser@linklaters.com

Netherlands

Dick Hofland
Partner – Tax
Tel: (+31) 20 799 6366
Mob: (+31) 6 5327 6466
dick.hofland@linklaters.com

Pim Horsten
Partner – Capital Markets and Banking
Tel: (+31) 20 799 6210
Mob: (+31) 6 5157 2707
pim.horsten@linklaters.com

Paul Kuipers
Partner – Capital Markets and Banking
Tel: (+31) 20 799 6318
Mob: (+31) 6 5337 3557
paul.kuipers@linklaters.com

Portugal

Nuno Ferreira Lousa
Partner – Dispute Resolution
Tel: (+351) 21 864 00 44
Mob: (+351) 91 439 96 38
nuno.lousa@linklaters.com

Pedro Siza Vieira
Managing Partner – Portugal
Tel: (+351) 21 864 00 14
Mob: (+351) 91 663 89 38
pedro.siza@linklaters.com

Spain

Sebastián Albella
Senior Partner – Spain
Tel: (+34) 91 399 61 60
Mob: (+34) 62914 9501
sebastian.albella@linklaters.com

Iñigo Berricano
Managing Partner – Spain
Tel: (+34) 91 399 60 10
Mob: (+34) 60791 5116
inigo.berricano@linklaters.com

Victor Manchado
Partner – Corporate
Tel: (+34) 91 399 6163
Mob: (+34) 66745 1434
victor.manchado@linklaters.com

Rafael Molina
Partner – Real Estate
Tel: (+34) 91 399 6045
Mob: (+34) 66130 1285
rafael.molina@linklaters.com

UK

Simon Branigan
Partner – Corporate
Tel: (+44) 20 7456 3309
Mob: (+44) 7900 057 894
simon.branigan@linklaters.com

Edward Chan
Partner – Banking
Tel: (+44) 20 7456 4320
Mob: (+44) 7795 962 499
edward.chan@linklaters.com

James Harbach
Partner – Capital Markets
Tel: (+44) 20 7456 4445
Mob: (+44) 7748 657 643
james.harbach@linklaters.com

Narayan Iyer
Partner – Banking
Tel: (+44) 20 7456 4837
Mob: (+44) 7584 487 322
narayan.iyer@linklaters.com

Tracey Lochhead
Partner – Corporate
Tel: (+44) 20 7456 2165
Mob: (+44) 7825 362 715
tracey.lochhead@linklaters.com

Matthew Monahan
Partner – Capital Markets
Tel: (+44) 20 7456 4629
Mob: (+44) 7866 421 941
matthew.monahan@linklaters.com

Kim Rybarczyk
Counsel – Banking
Tel: (+44) 20 7456 4653
Mob: (+44) 7917 469 424
kim.rybarczyk@linklaters.com

Deepak Sitlani
Partner – Capital Markets
Tel: (+44) 20 7456 2612
Mob: (+44) 7881 914 970
deepak.sitlani@linklaters.com

Kirsty Thomson
Partner – Banking
Tel: (+44) 20 7456 4465
Mob: (+44) 7748 936 851
kirsty.thomson@linklaters.com

Andrew Vickery
Partner – Capital Markets
Tel: (+44) 20 7456 4635
Mob: (+44) 7717 814 510
andrew.vickery@linklaters.com

US

Aaron Javian
Partner – Banking
Tel: (+1) 212 903 9148
Mob: (+1) 914 400 9953
aaron.javian@linklaters.com

Jeff Norton
Partner – Banking
Tel: (+1) 212 903 9115
Mob: (+1) 917 744 0730
jeff.norton@linklaters.com

Hong Kong

Matthew Middleditch
Global Head – Corporate
Tel: (+852) 2901 5352
Mob: (+852) 9017 6779
matthew.middleditch@linklaters.com

Dubai

Scott Campbell
Partner – Corporate
Tel: (+971) 4 369 5811
Mob: (+971) 50 552 6206
scott.campbell@linklaters.com

7089_F/07.15