Hogan Lovells

Hogan Lovells Lee&Lee

South-East Asian loan portfolio transactions

April 2016

Introduction

Since the 2008 credit crisis, South-East Asia has seen a rise in debt levels relative to national incomes. These high loan-to-GDP ratios can result in high debt servicing burdens.

Over the last two years, the on-going economic slowdown and dislocation in commodity prices have affected loan quality across South-East Asia. This effect has been amplified by deliberate devaluation of a number of Asian currencies, resulting in deterioration of debt-servicing ability among businesses and households. This is resulting in a rise in non-performing loans ("**NPLs**") in the region. World Bank data shows year-on-year increases in NPLs as a percentage of all loans in 2014 and 2015 in Indonesia and Thailand and rising trends in 2015 across much of ASEAN.

Banks in the region may consider opportunities to reduce these exposures and de-risk, by reference to a specific named borrower, corporate group, industry sector, geography or a combination of these elements. Where more than one such element is involved, a creditor will almost invariably select a portfolio of assets for disposal – potentially offering a "sweetener" to assist in the disposal of a particularly difficult risk or where the sale of a bundle of related risks makes sense from a strategic or balance sheet management perspective.

These conditions and trends will provide potential purchasers with varied opportunities for investment in credit across the region and may open possibilities for entry into markets which would not otherwise be open to a given investor. Understanding the structures by which such investments can be made will be crucial to getting the best possible result – particularly where a purchaser may wish to dissect the portfolio post-acquisition.

This Hogan Lovells Guide to South-East Asian Loan Portfolio Transactions seeks to highlight potential structuring and execution techniques and explains key initial considerations for potential investors.

We set out below a number of issues to consider in India, Indonesia, Vietnam and Malaysia and then describe the most common methods by which such transactions are effected. Finally, some key initial structuring issues are considered.

"Market expectation is that the number and size of NPLs will continue to rise over the next 12 to 18 months, as regional economies struggle and delinquent and restructured loans become bad debts."

Shaun Langhorne, BRI Partner, Singapore

In:

India

- the Reserve Bank of India (the "**RBI**") has not, at the date of this guide, issued any regulations or framework permitting sales of Rupee denominated loans (non-performing or not) to offshore investors;
- foreign exchange laws govern transactions between residents and non-residents of India. Loans can be made by non-resident entities to resident entities but the criteria may be different from the domestic loans sought to be sold and therefore whole loan sales may not be practicable or at the least need to be considered;
- transfers of loan portfolios where the loans are already from non-residents to residents (therefore resulting solely in a change to the non-resident lender) may be possible but will need to be reviewed on a case by case basis;
- banks, financial institutions and non-banking financing companies are permitted to sell their NPL portfolios to asset reconstruction companies ("**ARCs**") and securitisation companies set up in India for distressed debt management (subject to certain conditions prescribed by the RBI). A foreign entity can invest equity up to 100% in ARCs of which any investment above 49% requires prior approval of the Foreign Investment Promotion Board of India;
- another form of offshore investment in ARCs is by way of investments in unlisted security receipts (similar to a securitisation note) issued by such ARCs, where the Government has permitted foreign investors to invest up to 74% of any issuance;
- there may be other vehicles like non-banking financial companies that foreign investors can also consider establishing and using to purchase whole loans;
- synthetic structures are not customarily used by foreign entities looking to invest in Indian loan transactions.

Indonesia

- a lack of specific regulation on debt sale and purchase within the financial regulatory environment means that rehabilitation of NPLs is largely subject to contractual principles set out in the Indonesian Civil Code;
- the concept of trust is not recognized and synthetic structures may be subject to liberal interpretation by the courts. Documentation should allow for alternative dispute resolution and flexibility in the execution process;
- the on-going development of legal process in the provinces means that ownership and security registration, as well as powers of attorney issued to perfect security within these areas, continue to require rigorous verification;

"The ability to effect such an investment will require a detailed understanding of the constituents of the NPL portfolio itself as well as the regulatory environment applicable to it."

Alexander McMyn, Banking Partner, Singapore

– external debt may be subject to hedging ratios comparing foreign currency assets of the obligor to its foreign currency liabilities against specific maturity periods;

– under the current controlled foreign investment regime, regulatory approval for assignment of rights and direct ownership of assets to a foreign purchaser may be subject to foreign investment and industry specific regulatory process and approval.

Vietnam

– the highly administered nature of the jurisdiction means that, notwithstanding apparently permissive debt documentation, compliance with certain procedures and forms of transfer set out in State Bank regulations on "debt sale and purchase" may be required (including the requirement for obtaining obligor consent to the transfer);

– stringent foreign exchange controls mean that the "exporting" of a local NPL from a Vietnamese credit institution or foreign bank branch operating in Vietnam to a foreign lender will require registration with the State Bank of Vietnam, which may review compliance with local regulations in connection with the debt transfer;

– participation by an offshore lender in security packages may, particularly if real estate is concerned, be problematic;

– synthetic structures for risk participation are not supported by Vietnamese law, and are therefore in practice typically established outside Vietnam and governed by a law other than Vietnamese law.

Malaysia

– banking institutions may sell NPLs to (i) domestic banking institutions or locally-incorporated foreign banking institutions in Malaysia; (ii) domestic investors; or (iii) foreign investors;

– cases (ii) and (iii) must be conducted through a Malaysian incorporated and tax-resident SPV where the foreign equity participation is capped at 49% (note that this limit does not apply to locally-incorporated foreign banking institutions);

– Bank Negara Malaysia approval is required before disclosure of any confidential information relating to borrowers, including in a due diligence exercise[1].

[1] The disposal of NPLs in Malaysia is currently governed by the 2006 Guidelines on the Disposal/Purchase of Non-Performing Loans by Banking Institutions

Structure and execution techniques

The ability to transfer a loan portfolio, together with the form and method of such transfer, will depend on a number of factors, including: the nature of the assets comprising the portfolio; the jurisdictions in which the risks are booked; the nature and location of any secured assets supporting the risks; and the place from where the seller and the purchaser deal.

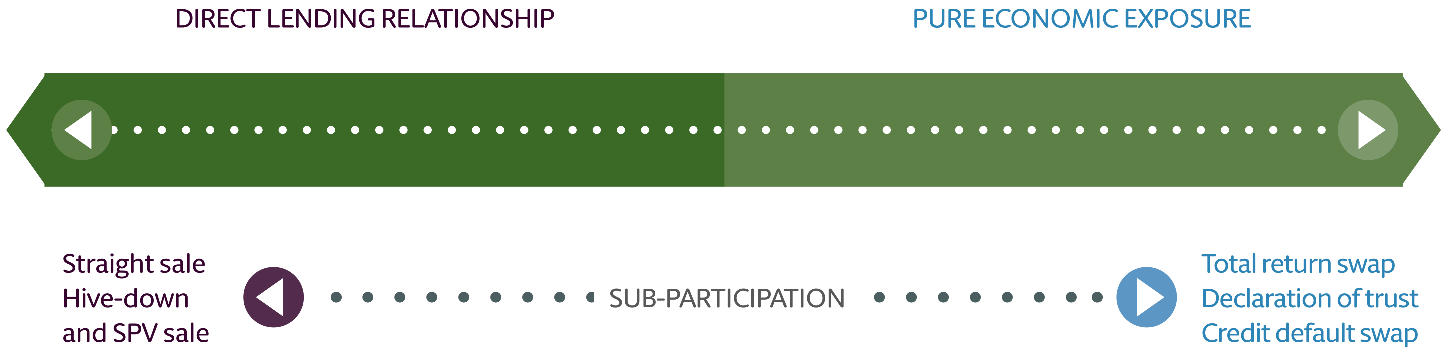
As with any complex financial transaction, tax and regulatory considerations will play a key role in structuring the deal.

Ultimately, the transfer methodologies chosen will depend on the commercial objectives of the purchaser and the seller, the level of control each wishes to exert over management of the portfolio following completion of the sale and the nature of the relationship each of them wishes to maintain with the ultimate debtors post-closing.

A given portfolio transaction may lend itself to one or more execution techniques and the techniques themselves are capable of considerable flexibility, allowing effective counsel to add value by tailoring solutions to the needs of a given transaction.

We set out below a description of those which are most commonly deployed and comment briefly on their pros and cons. With one exception, the methodologies are categorised by reference to the extent of the relationship the purchaser will have with the debtor post-closing. The exception is sub-participation which is a very flexible concept capable of being used across the spectrum of desired outcomes.

The diagram below shows how the various methodologies can be grouped depending on the proposed level of exposure the purchaser will have to the portfolio debtors:



"Structural options range from "direct lending", enabling the purchaser to establish a new relationship with the borrower to pure "economic exposure", giving the purchaser a return for accepting the selected risks without establishing any such direct relationship."

Mark Cooper, Corporate Partner, Singapore

Structures resulting in direct lending relationship for purchaser

Straight sale

Outright disposal of loans and related rights/obligations

- Allows exit from asset base/ jurisdictions/ sectors
- Assets removed from balance sheet in return for purchase consideration

- Potential contractual consent restrictions
- Transfer taxes in certain jurisdictions
- Loss of any relationship with original customer
- Potential withholding tax issues depending on location of purchaser

Hive-down and SPV sale

Transfer of loans to a subsidiary SPV and sale of shares in SPV

- Typically consents not required
- May be more tax efficient
- Portfolio seller can manage pre-sale preparation, resulting in ease of final execution

- May trigger stamp duty
- Needs a reasonably sized portfolio to be worthwhile

Structures resulting in pure economic exposure

Total return swap ("TRS")

TRS purchaser receives income and any capital gains (i.e. total return) from the underlying loans in exchange for making periodic payments, either fixed or floating, to TRS seller

- Allows TRS purchaser to gain economic exposure to, and benefit from, the assets without having actually to own them
- Option to import the underlying contractual restrictions
- Ownership of assets may remain with TRS seller, depending on settlement method

- TRS purchaser can determine how "remote" it wishes to be from borrowers and assets
- From TRS seller's perspective, TRS may not result in a clean exit from portfolio

Declaration of trust

Seller declares trust over portfolio assets in favour of purchaser

- Risks remain with the seller
- Contractual restrictions may apply

- Many jurisdictions do not recognise the concept of a trust
- Insolvency of seller may delay recovery of trust assets
- Detailed negotiations may be required in respect of conduct of portfolio post-closing

Credit default swap (“CDS”)

CDS purchaser makes agreed periodic payments to CDS seller up to the maturity of the CDS and in the event the debt issuer or borrower of the Reference Obligations defaults (i.e. a “Credit Event” has occurred), CDS seller will pay CDS purchaser the market value of that debt obligation

- Transfers the credit exposure of the portfolio to the CDS seller without any funding obligation.
- Option to import contractual restrictions
- Maintains confidentiality in relation to loans
- Gives exposure to particular borrower types, jurisdictions and sectors

- Risks bought must qualify as “Reference Obligations” for settlement purposes
- Collateral may be required to support payment obligation

Sub-participation

The attraction of sub-participation is its flexibility: it may be deployed either on a “disclosed” or “undisclosed” basis, depending on whether the parties wish the debtor to be aware of the risk transfer. Equally, a sub-participation can be structured on a “funded” or “unfunded” basis – the former being akin to a loan purchase on the date of completion and the latter typically resulting in an obligation on the risk buyer to contribute funding only following default by the debtor. In all cases, the legal title to the risk will remain with the original creditor – and so this methodology is not appropriate where it is imperative that the original creditor should be released as a party to the underlying transaction.

“The attraction of sub-participation is its flexibility.”

Alexander McMyn, Banking Partner, Singapore

Initial key issues

We set out below a number of key issues that the purchaser and seller of a portfolio will need to consider the relative importance of each will depend on the commercial aims of the parties.

Due diligence

- Borrower population
- Amounts outstanding
- Interest rates
- Secured/unsecured
- Asset classes
- Repayment profile
- Nature of any outstanding defaults and consents/waivers already given
- Applicable transfer restrictions
- Post-closing steps required to perfect transfer of portfolio. Can borrower(s) be compelled to assist? Who bears costs?

Valuation
Execution
Certainty

Contractual

- Clarity on assets and liabilities to be transferred/excluded
- Clarity on % of outstanding loan being sold (i.e. will purchaser achieve a voting quorum under a given financing?)
- Protections around accuracy of data tape
- Varying execution structures for blended portfolios
- Coverage for regulatory/ mis-selling issues
- Process and mechanics for regulatory, anti-trust and third party consents
- Migration and integration
- Allocation of risk on shortcomings of the assets/portfolios
- Option of cash or physical settlement of TRS or CDS depending on the market (i.e. to replicate exposure to loan synthetically or to physically "sell" the loan)
- Decision-making processes and rights surrounding portfolio and enforcement

Valuation
Execution
Certainty

Tax/Regulatory

- Is purchaser authorised locally to enter into a debtor/creditor relationship with the borrowers?
- Will payments at closing or cashflows in the portfolio post-closing trigger unforeseen taxes?
- Will disposal trigger tax consequences for seller, will any tax losses on sale be capable of being set off against gains?
- Will transaction achieve the desired regulatory capital and accounting treatment for each of purchaser and seller?
- Disclosure requirements to regulators/government authorities in the jurisdiction of the purchaser and seller. Will a TRS or CDS be similarly caught?
- Restrictions on the trading of or mark-to-market valuation of CDS or TRS
- Currency controls applicable to TRS or CDS, if cash-settled

Valuation Execution Certainty

We would like to thank Skrine and Cyril Amarchand Mangaldas, with whom we regularly work on deals involving Malaysia and India respectively, for collaborating with us in the production of this note.

Contacts

Alexander McMyn
Partner
Singapore
T +65 63022 554
alexander.mcmyn@hoganlovells.com

Samantha Campbell
Partner
Hanoi and Ho Chi Minh
T +84 8 3822 6198
samantha.campbell@hoganlovells.com

Shaun Langhorne
Partner
Singapore
T +65 63022 453
shaun.langhorne@hoganlovells.com

Bronwen May
Partner
Hong Kong
T +852 2840-5630
bronwen.may@hoganlovells.com

Mark Cooper
Partner
Singapore
T +65 63027 140
mark.cooper@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Brussels
Budapest
Caracas
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jeddah
Johannesburg
London
Los Angeles
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Rio de Janeiro
Riyadh
Rome
San Francisco
São Paulo
Shanghai
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar
Warsaw
Washington, D.C.
Zagreb

Our offices
Associated offices

www.hllnl.com