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Securitization of Non-Performing Loans

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1. INTRODUCTION

1.1. WHY SECURITIZE NPLS?

Non-performing loans (NPLs), credits in a default or distressed situation, constitute a serious problem for banks worldwide. Not only do they represent less income, but also trigger additional and somehow exceptional costs for credit institutions. The recovery and enforcement procedures inevitably require banks to set up and maintain internal structures allocated exclusively to dealing with borrowers in a default situation and, most of the time, with the underlying judicial proceedings, all of which activities that are alien to the core business of banks. This is costly, in that it implies the engagement of specialized employees (including lawyers), the establishment of internal structure and procedures for liaison between the credit risk, the commercial and the enforcement departments, and it triggers court and enforcement expenses, as well as real estate registration costs associated with the underlying assets that serve as collateral for the loans.

From a regulatory and accounting perspective, NPLs will often require banks to consume their own funds by keeping the assets in their balance sheet, accrued with the requirement to create provisions to make up for potential losses, which

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inevitably impact on financial ratios of credit institutions and, ultimately, on their financial results. Furthermore, and specifically in the context of mortgage-backed NPLs, the enforcement of the mortgage, that shall be carried out through a judicial procedure which is unforeseeable in terms of time consumption and outcome, will usually require banks to expose themselves to real estate risk, which from both a commercial and a regulatory perspective will surely raise concerns.

These concerns become even more stringent in countries where banks have, particularly in the last three decades, engaged in highly aggressive loan strategies, both for residential and commercial purposes, which lead lenders not only to borrow money at low cost, but also to relax the requirements and eligibility criteria for the borrowers, whether corporations or individuals. Here, the consequences of high levels of NPLs may have a negative impact, not only on the credit institutions themselves, but also on the financial system and even on national economies, most of all in those countries where the level of real estate leases is quite a bit lower than the level of the own houses.

In this context, the financial markets have seen a spate of transactions mostly with national (retail) banks selling large portfolios of loans to international investment banks with one goal in mind: to clean their balance sheets from those inefficient, costly and risky assets, in exchange for immediate liquidity and, indirectly, a reduction of operational and financial costs. And, for a number of different reasons, it is here that the disposal of NPLs under a securitization-like framework is beginning to appear as a trustworthy, efficient alternative.

First, the sale of loans for securitization purposes allows banks to sweep significant portions of bad quality assets out of their balance sheets, allowing them to free a significant proportion of their capital and to meet in an efficient way the applicable capital-adequacy ratios and thus to comply with the regulatory rules to which they, as supervized entities, are subject. By doing that, originators will not only be raising and immediately receiving extra funds, which may be used to make new investments, borrow more money and continue expanding their credit granting activity, but will also limit and reduce their exposure to the risk associated with non-performing loans, thus allowing, in most circumstances, the release of provisions imposed by the applicable regulatory and accounting rules.

Moreover, the disposal of portfolios of NPLs in a securitization context allows banks to shrink their own internal structures engaged in recovery and enforcement against the borrowers, thus cutting down significant fixed costs and allowing banks to further concentrate and dedicate their resources on their core business. In this scenario, the sale of NPLs could be seen as an efficient reaction from the bank to a certain loan which is following the wrong route in terms of repayment: instead of spending time and money trying to enforce and recover the credit entitlement arising from said loan, the bank assigns that task to a third-party who will carry out such an ordeal applying its own specialized teams and methods.

Second, and this is where securitization can really make the difference in terms of attractiveness for banks wishing to clean their balance sheets, the setting up for securitization structures is suitable to provide better deals for the originators, and thus to enhance their income associated with the disposal of

portfolios of NPLs. The sale of the NPL portfolios and the assignment of the enforcement and recovery of the credit entitlement tasks to a third party are also a feature where the fierce competition among banks comes into play and where every penny counts: the usage of securitization vehicles and the efficient features in which they have been developed in various jurisdictions enables the increase of the purchase price payable to the banks on the sale of the NPL portfolios, evens when already benefiting from a significant discount, a purchase price that will be immediately received by the originator.

There are a number of reasons, in our opinion, for the better price that can be offered to banks where the funds are raised through the issue of notes backed by the NPL portfolios. The setting-up of asset-backed structures reaches large bases of diversified investors, who are willing to take on the risk associated with the relevant underlying assets, in exchange for the enhanced protection provided by limited recourse and assets-segregation features usually associated with securitization structure. The liquidity and free transferability of the asset-backed securities serves as an additional incentive for investors in the business of NPLs. Tranching allows the structure of investments that appeal to investors with different risk-return profiles, thus enlarging the investor base. Also, where credit ratings may be associated to the securities issued, the cost of analysis and due diligence of the portfolios decreases and may better be diluted, and the investor less money conducting due diligence on the underlying and being willing to pay more on the notes. The creation of securitization structures will normally involve large portfolios, either in one shot deals or by establishing revolving mechanisms, which will not only marginally reduce the costs associated with, and triggered by, the underlying assets, but will also reduce exposure to risk by investors: the size and diversity of the securitized portfolio will allow the market to rely more and more on statistical data and macroeconomic information than on actual valuation and assessment of the entire pool.

In addition, securitization deals can work as efficient tools in light of the types of assets at stake (such as real estate and equipment), by introducing market pressure in the management of such assets to create or increase revenue flows, ultimately benefiting the seller of the assets. In fact, and taking into account the peculiar nature of those types of assets backing the relevant receivables, the structures will require the involvement of specialized and sophisticated servicers, who will manage such assets and ensure the relationship with the debtors in accordance with higher and more efficient standards, thus rationalizing their use and improving their revenues.

Also, and this can also serve as a powerful incentive, sellers of NPL portfolios may still retain an interest in the portfolio through a number of contractual features established either at the level of the assignment agreement or at the level of the specific features asset-backed securities issue. In particular, deals can involve deferred purchase price mechanisms that will allow further payments to the seller bank where the portfolio outperforms the anticipated values, or, alternatively, by having the originating bank acquire a junior tranche of the notes issued, thus being entitled to receive the excess spread received from the securitized portfolio, after

the senior investors' payment entitlements have been duly satisfied in light of agreed payment priorities.

Finally, it is also true that, at least in most European jurisdictions, the enactment by governments of securitization-friendly legal regimes, including in what concerns the corresponding tax treatment, is susceptible to working as the decisive push to pursue the securitization route. Indeed, specific features inherent in the securitization frameworks may, in most cases, prove to be the decisive advantage for selling NPLs to a securitization vehicle. More flexible, investor-friendly, market-protective efficient rules relating the assignment of credits may apply and thus reduce costs, mitigate risks and enhance management of the underlying loans. In particular, securitization-specific laws may waive certain cumbersome formalities and registration requirements for the assignment of both the credit and the underlying security, making it possible to set up and securitize large portfolios apart from operative obstacles that may not have been properly considered in the general assignment of credits provisions. Insofar as the investors are concerned, securitization laws, particularly in Continental Europe, aim at providing consistent protection and security, mainly through the principles of asset segregation and limited recourse of the investors, as well as through legal creditors' privilege, which grants an essential ranking status. Furthermore, securitization vehicles are usually regulated entities, hence subject to close scrutiny by the relevant market supervision authorities. Moreover, securitization structures may be awarded attractive and neutral tax regimes that take into account the specific purposes of securitization transactions and provide them with adequate tax treatment in order to work out as an actual useful tool. All these features, we understand, may be very appealing to investors, as they can offset the risks and uncertainty that, inevitably, are attached to a portfolio of NPLs.

1.2. Common Obstacles to the Securitization of NPLs

There are naturally specific problems, obstacles and risks that need to be taken into account when setting up a securitization structure involving NPL portfolios. These come on top of those usually considered in the securitization market. For instance, it is naturally necessary to ensure that the returns on the deal are sufficient to cover the standard costs of securitization, bearing in mind that, in the NPL market as in other standard credits securitization transactions, there is always an issue of size to be considered from the start (so that the transaction costs may properly be distributed and an efficient all-in-transaction cost achieved). Accordingly, the particular nature of the receivables, notably their non-performing condition, will not set aside the common obstacles that may be identified under a securitization transaction using more standard receivables, but rather take on board, in addition to those common obstacles, other specific concerns when assessing the feasibility of an NPL securitization.

Naturally, information may be a concern, in that investors may find it hard to assess the characteristics of the securitized portfolio and, therefore, have difficulty in assessing the underlying risks associated with the portfolio. As we have said above, this concern will be less important as the size of the portfolio gets bigger, and if a credit rating is assigned to the issue. Nevertheless, it is definitely a major concern when setting up the structure, and it will require appropriate due diligence and adequate disclosure of the findings and of all relevant data relating to the portfolios, in the offer documentation.

Probably the most stringent concern has to do with the servicing of the loans. In 'standard securitization,' particularly of mortgage-backed credits, the servicing is usually retained by the originator bank, which maintains all relationships with borrowers and collects the amounts due under the securitized credits, even if in a (subsequent) enforcement context. With NPLs, instead, the originator banks, for the reasons explained, have all the incentives to transfer the servicing of the credits to the purchaser of the portfolio. Accordingly, the securitization structure must accommodate a third party servicer, who will assume full responsibility for collections and recovery of the amounts due from borrowers.

But other factors contribute to making the servicing of the portfolio of NPLs an issue, mainly related to certain additional costs that securitization of good quality credits will not trigger. First, the fact that the originator gets out of the picture, and leaves the servicing of the credits to a third party will, in most jurisdictions, inevitably require that the relevant purchaser registers in its name the benefit to the acquired credits and, particularly, to the underlying security interest, a procedure that is usually waived in securitization of performing credits, where the seller retains the servicing of the credits. This may trigger significant costs and impose a cumbersome process, which needs to be taken into account in estimating the time-frame of the transaction. Also, the fact that the credits are being enforced triggers additional and, sometimes, unforeseeable costs, which may depend on the duration of the court proceedings and the defences raised by the borrowers, among other factors. Again, these costs must be built into the financing structure, and may not always be negligible.

Nevertheless, we believe (and real life practice seems to confirm, as do recent trends in the European securitization markets) that these risks and specific concerns are not significantly different from those that arise in transactions of high-quality assets and thus, particularly when the right classes of assets are chosen and when the envisaged objectives are attainable, a cost-benefit assessment will highlight the advantages of setting up securitization deals involving NPL portfolios.

1.3. Recent Trends in the European Market

While it is true that the NPL market in Europe seems to be going full steam ahead, notably in countries where economic recession was more intensely felt, it is also true that securitization is not yet a generally used tool for financing (or

refinancing) the acquisition of large portfolios. Legal, regulatory, tax, accounting and even cultural obstacles have been delaying the inevitable.

However, 2006 has probably been the year of change. This is because it witnessed the first securitization of NPLs set out in Germany: Bluebonnet Finance, a 1.34bn euros (EUR) deal managed by Citigroup and launched in late 2006.

This deal involved a large portfolio comprising commercial and residential mortgage credits. It was subdivided into three sub-portfolios: A performing sub-portfolio, representing 17 per cent of the asset pool, a non-performing sub-portfolio, amounting to 62.3 per cent of the asset pool, and a sub-performing sub-portfolio, representing the remainder of the securitized pool. In total, the deal was worth EUR 2.8bn, and was thus the largest European securitization of NPLs to date. As particular features of the transaction, it is worth noting the large tranche of triple A rated notes, the innovative hedging structure, combining the flexibility and reduced costs required by the sponsor with the demands from the rating agencies for stress scenarios, as well as the equity incentives built into the structure to service the portfolio in such a way as to outperform the initial business plans. Also interesting in this deal was the time between the acquisition of the portfolio, which occurred in 2004 when private equity firm Lone Star Partners bought the assets from Hypo Real Estate, and the actual launching of the securitization. The almost 18-month period that elapsed prior to going public allowed the sponsors and the servicers of the deal to prepare careful and detailed business plans for the various categories of loans comprised in the portfolio to be securitized, thus setting the stage for a smoother and certainly more efficient servicing of the assets, ultimately to the benefit of investors.

Germany is recognized as one of the largest NPL markets in Europe and for years this assets class was expected to finally fuel securitization structures. Now that the first big deal has been unveiled, more are expected to enter the pipeline.

The potential for securitization of NPLs is being increasingly recognized in other parts of Europe too. Legislation in countries such as Italy, France, Spain and Portugal does not generally prevent securitization of this asset class, while at the same time provides for flexible legal features regarding the assignment of the credits and the underlying security, the protection of the holders of the securitization notes and the bankruptcy remoteness of the securitization vehicles. In these same countries, the trend for increased diversification of the securitized assets renders more or less inevitable the securitization of NPLs.

In Italy, for instance, favourable tax treatment for losses meant that non-performing loans have significant potential for securitization. Accordingly, some deals have been set up in recent years.

In Portugal, for instance, 2006 has seen the first 6 issues of securitization notes backed by NPLs, both mortgage-backed and unsecured. This is a major achievement and an innovation for the Portuguese securitization market, and although volume is still not significant (at least by European standards), the legal ‘technology’ for securitization has been put in place for portfolios of NPLs. Hence more transactions of this sort are expected to follow in the course of 2007.

Moreover, the increased diversification of securitized asset types, the implementation and success of new and innovative legal structures and the promising results achieved by NPL securitization structures show that securitization can indeed serve as a powerful financial tool capable of being used in advantageous legal environments. It also allows banks to release the burden of NPLs on their balance sheets, and thus creates opportunities for further investment and value creation.

2. SETTING UP THE DEAL

2.1. Getting Started

As always, getting the deal started will require a full and in-depth knowledge of all elements, variables and factors that may have a direct or indirect impact on the feasibility, soundness and reliability of the structure. Due diligence, research and investigation are crucial preliminary tasks on which the success of any NPL securitization depends heavily.

A specific feature of NPL structures, which results from the lower quality of the securitized assets and thus from the higher exposure to default risks and stress scenarios that are typical of this asset class, is the need for in-depth research and knowledge of the macroeconomic context of the local markets, and even of the political and social context that surrounds the structure. This is surely of fundamental importance in order to make an accurate estimation of performance by borrowers, to better understand the various profiles of such borrowers and to predict any movements in the underlying real estate market, not to speak of the relevance of assessing the social and political risks of a particular market.

Likewise, attention must be paid to the gathering of good historical data (preferably going back at least as far as ten years) and to the quality of the due diligence conducted in respect of the relevant assets, as well as adequate due diligence with respect to the legal framework that applies to such assets (origination, enforcement, servicing, etc.), particularly in stress scenarios. In any case, the growing resources of historical data, market analysis and monitoring of performance of corporate entities, together with an adequate level of disclosure of the methodologies used, will surely make life easier in this respect.

2.2. Key Contractual Features

The hard work does not end with thorough due diligence and investigation of all factors that may have a direct and indirect impact on the deal and, in particular, on the portfolio to be securitized. The contractual structure of the deal must also reflect and accommodate the specific features, risks and upsides that are inevitably attached to an asset class such as NPLs.

The additional and inevitable uncertainty about the quality of the securitized portfolio may be compensated by strict and detailed representations by the seller. The higher volatility both in the collections to be received and in the costs and expenses triggered by the servicing of the securitized pool call for contractual mechanisms aimed at ensuring adequate flexibility to the structure, while not putting at stake its stability and security. The specificities associated with the servicing of bad quality loans also require the contractual structure to award significant roles, tasks and discretions to the servicer, while at the same time putting in place strong monitoring devices for the ultimate benefit of note holders. These, among other particular concerns, are some of the features in respect of which lawyers are expected to strike the right balance between flexibility (notably for the issuer in matters concerning payments due under the relevant notes, as well as to the servicer, mainly in matters concerning collections-and-enforcement procedures) on the one hand, and soundness of the financial structure, which must boost a predictable yield level for note holders, as well as a foreseeable exposure to default risk, on the other hand. In the following few pages we will present some of the contractual mechanisms that may help lawyers attain such goals.

2.2.1. Full disclosure: Relying on Seller's Representations and Warranties

In any securitization structure, the set of representations and warranties given by the originator, and associated mechanisms for control of its completeness and accuracy, is of key importance for the soundness of the deal. Firstly, it provides crucial comfort to the arrangers and lead managers as to the quality of the assets underlying the securities they will place on the market. Secondly, it plays a fundamental role in the process of credit rating of the transactions, by setting the standards that will apply to the assets that will be deemed eligible as collateral for the relevant issue. Finally, it can even be useful, in some jurisdictions, to help confirm to the supervisory and market authorities that the legal eligibility criteria established by the relevant securitization framework is duly met.

But if the above is true, and thus if standard representations and warranties (such as the usual corporate representations and those referring to good title by the seller or to the absence of offset entitlements of the borrowers) remain crucial in an NPL securitization, there is little doubt that the relevance of the representations and warranties given by the seller (and associated contractual features) in respect of the contents of the portfolio being sold becomes even more important in the context of the securitization of NPLs.

First, the reduced quality of the assets to be securitized requires a more detailed and in depth description of the loans included in the portfolio. This means that through both the representations and warranties and the associated schedules, the seller should convey all elements that allow the purchaser full identification

not only of: (i) the loan itself (i.e. principal, overdue interest, interest rates, etc.), but also (ii) of the original borrower and possible guarantors, and (iii) of the underlying asset/s serving as collateral and particularly of the mortgaged property, specially in a context where the chances of recovery are inevitably linked one way or another with the quality of such an asset.

This means, therefore, that appropriate representation requires description and assurance of the features of the contents of the NPL portfolio and the underlying assets, which is particularly relevant where the securitized portfolio includes loans backed by mortgages, in which case it is fundamental to insert in the sale document a complete and accurate description of the lien and of the property itself, so as to allow both the registration of the mortgage on behalf of the purchaser, and, if that ends up to be the case, a smooth enforcement of the guarantee. Also, and in order to reduce the real estate risk that will inevitably be attached to the securitization of NPLs having mortgage credits as the underlying assets, the representations and warranties may further include real-estate specific information, related particularly to: (i) the status and ranking of the underlying mortgaged or other guarantees, (ii) the current state of conservation of the properties (usually measurable through periodic evaluation reports held by the originator), (iii) the presence of all governmental and administrative approvals related to the properties that may be required to conduct a subsequent sale, (iv) the absence of environmental liabilities, and even (v) the current tax status of the property. This is because, if the purchasers are not protected in these areas, they may end up owning a property which they cannot monetize, or which may bring about additional costs and liabilities, to the detriment of the securitization cash-flows structure and, thus, to the detriment of the investors.

Moreover, in respect of assets that are already the subject of court enforcement procedures, the representations must not only expressly confirm that all such court proceedings have been, up to the date of the assignment, properly commenced and pursued, but also include the details of all such proceedings, so as to allow the purchaser to replace the creditor without hindrance. These representations shall then be coupled with contractual covenants whereby the seller commits to deliver to the purchaser all documentation required for the latter to fully assume its position as the new owner of the credit, including, for all relevant purposes, in the corresponding court procedure.

One note, however, to indicate that this line of reasoning may not be stressed to an extent beyond the capacity of originators to accept extensive coverage of these matters in the documentation pertaining to each transaction, namely bearing in mind the nature as assets of the credits being sold contact for these transactions need to be straight forward and easy to negotiate and implement. Time of contracting is usually of the essence in these deals and therefore a long and extensive negotiation for these contracts is usually not in line with the parties' interests. This is therefore an area where the risk and reward equation most assuredly needs to be properly considered by the parties when negotiating these transactions.

2.2.2. Protection for Breach of Seller's Representations and Warranties

Naturally, representations and warranties do not work alone. They provide the picture of the portfolio to be securitized, which is expected to be as correct, complete and accurate as possible in light of the particular nature of the NPLs being sold, but they then need to be followed by reliable and effective contractual mechanisms that both permit the purchasers to monitor the ongoing correctness, accuracy and completeness of the information provided by the seller under the representations and warranties, and allow them to deal with situations where a breach of those representations and warranties occurs and where, accordingly, adequate indemnity and compensation provisions must enter into play.

Specifically, in matters relating to the breach of representations and warranties given by the seller regarding the securitized portfolio, the relevant sale agreement should include full force protection of the purchaser in order to ensure that any subsequent event relating to a particular loan in respect of which such breach has occurred does not hinder the transaction cash flows and, thus, the position of investors. This is, of course, an important feature of standard credit securitization, but it is even more so in an NPL structure, where the quality of the assets is riskier and thus the likelihood of default higher.

Therefore, the sale contracts must provide for clear and straightforward mechanisms whereby, following a breach of an asset representation and warranty which is not remedied within a reasonable timeframe, the purchaser becomes immediately entitled to receive an amount equivalent to the nominal value of the relevant loan, plus (i) all costs and expenses incurred by the purchaser (through the servicer) in connection with the loan, and (ii) a default interest rate over the nominal value of the loan (or at least the price paid for it). This default interest rate serves the crucial purpose of providing the sellers with the incentive not to include in the pool assets that they know (or might reasonably know) do not meet the eligibility criteria agreed for the transaction and the contents of the representations and warranties given on the portfolio.

Naturally, the more thorough, complete and accurate the set of representations given by the seller, the more effective this mechanism will be. And that's why in most jurisdictions the secret behind a successful deal, and a solid financial framework, is to know the local markets in depth, not only banking, but also (in the case of mortgage-backed NPLs) the construction and real estate markets too, so as to build into the disclosure components of the deal all information that may be of use when the purchasers are faced with underperforming assets and when, accordingly, they may seek indemnification from the seller ultimately to the benefit of the investors.

But in this respect, a balance definitely needs to be achieved since, on the originator's side, there is also a natural and understandable resistance to the extension of secure packages of the representations warrants on the portfolio, precisely because it corresponds to a portfolio of stressed assets and, by definition, a portfolio

comprising riskier situations. As in most such transactions, the risk and reward equation will ultimately determine the point of balance.

2.2.3. Size Matters and Credit Ratings Too: Credit Enhancement Features of NPLs' Portfolios

We have highlighted above those factors that are usually mentioned as the essential risks triggered by the securitization of NPLs. The uncertainty of steady, reliable or even predictable cash-flows, the extreme reliance on the servicer, the difficulty of building big enough portfolios without jeopardizing a credible eligibility criteria or the higher exposure to real estate risk are just some of those risks. Hence, adequate amortization structures, adequate collateralization levels, revolving structures, deferred purchase price/equity pieces mechanisms and high advance rates, coupled with adequate swap and liquidity arrangements to ensure interest payments even in case of momentary shortfalls, are crucial to the structure's stability. Indeed, following a careful study of the structures currently being implemented (involving NPLs but also other asset classes with similar risk exposures), we believe that there are several crucial legal features which are required for the smooth setting-up of reliable, solid NPLs securitization structures, and which are capable of achieving significant credit worthiness levels and therefore accessing a broad base of investors.

Size problems may be solved through the implementation of reliable revolving structures, whereby the seller and the purchaser agree to conduct further assignments of future loan agreements. This may be done in accordance with a predetermined calendar (e.g. with monthly, quarterly or biannual further assignment dates) or, instead, under a streamlined procedure allowing for a continuous transfer of loans from the seller to the securitization vehicle.

Liquidity is also a concern that needs to be addressed in light of the specific nature of an asset class such as NPLs. And not only liquidity for making payments to investors, but also for dealing with the unexpected (but not uncommon) expenses and costs triggered by the servicing of the pool.

As far as the payments to note holders are concerned, liquidity and hedging arrangements are naturally crucial, but it is probably the tranching of the notes that will play a key role. Through tranching mechanisms, it will be possible not only to allocate and diversify the risk in accordance with the investors' specific profiles and investment policies, but also to create deferred interest features that will allow mezzanine or junior investors to be paid, even if at a later stage.

As to the costs and expenses associated with the servicing of the securitized pool, the contractual documentation must allow for flexible ways to transfer to the servicer any amounts that may be required to be spent in order to maintain the value of the assets serving as collateral.

Size matters as it also facilitates more efficient solutions to many other issues. However, this is also a matter in which the rewards associated with implementing larger transactions may not entirely compensate for the risk of staying out of the

market simply because a sizeable portfolio takes time to build, especially in the smaller European economies.

2.2.4. Providing Incentives to, and Monitoring, the Servicer

We have, more than once, highlighted the crucial role played by the servicer in an NPL securitization structure, bearing in mind that it will typically correspond to that of an independently-contracted party. The servicer's performance is particularly important in the context of this type of asset. Here, too, lawyers are expected to strike a balance. On the one hand the servicer is expected to perform its role with flexibility and discretion and in the context of a riskier, unpredictable and volatile portfolio of assets. On the other hand, reliable monitoring of the ongoing performance of the servicer, and any possible sub-servicers or sub-contractors, must be put in place so as to ensure that the servicing of the pool is made in a timely and efficient manner capable of generating sufficient liquidity to service the portfolio debt.

While the initial selection of the servicer plays a fundamental role, it is also true that the servicing agreement must, from the very outset, set adequate and clear performance goals for the structure being contemplated. This means that proper attention should be paid to the preparation of the transaction's collections flows, and to the servicer's adherence to adequate standards of performance, thus ensuring compliance with the transaction's business plan. Accordingly, the servicing agreement must provide: (i) for the obligation of the servicer to prepare a business plan for the portfolio, with a reliable estimation of the in and out cash-flows, and (ii) for ongoing monitoring of the level of compliance by the servicer with the business plan.

These business plans, which act as a crucial keystone in the financial structure of any securitization of NPLs, must take into account the servicer's experience and knowledge of the local markets, particularly with respect to the characteristics of the borrowers, the enforcement and administrative context in which recoveries are to be made, the legal environment applicable to the loan and its underlying security, and inevitably the real estate market. With these and other elements in mind, the business plan should then establish the main exit strategies for the assets included in the portfolio, establishing the overall framework for the resolution of each such asset, in terms of timeframe and types of resolutions expected to be implemented (whether through refinancing or restructuring, resale of the loan to a third-party, full enforcement in court for subsequent sale of the asset serving as collateral, or other strategies), thus preventing or mitigating 'moral hazard' risks to the servicer through continuous surveillance of the performance of the transaction until completion, notably by means of proper and regular servicer/investor reports and regular contacts with the servicer.

Of fundamental importance, also, may be the feature of keeping the servicer 'on board,' by granting it equity or quasi-equity as incentives to go beyond the minimum demands of the role.

For this purpose, the servicing agreement may, insofar as the remuneration of the servicer is concerned, provide for certain triggers that, once outperformed, allow for the servicer to retain a further remuneration for its services and even (when this is desired) a level of equity or quasi-equity leakage of the portfolio. These triggers may relate to a number of different features of the portfolio, from the number and volume of resolution of loans, to the level of outperformance in relation to the initial and updated business plans or even to specific thresholds applicable to certain geographic locations or to special subtypes of assets or of borrowers. This goal can be achieved through variable components of the servicer remuneration, or through the proceeds received by the junior tranches of the notes issued.

To a greater extent than in the securitization of performing assets, the role of the servicer is crucial in the NPL context, where there are unquestionably sound reasons to expand on the features governing the monitoring and the constant reporting on the performance of the portfolio (therefore demanding more from the servicer). The greatest remuneration feasible should be offered for the servicer's creativity and in order to incentivize performance. The risk and reward equation is again relevant in this context.

3. FINAL REMARKS: ALBEIT THE DIFFICULTIES, THE WAY AHEAD

In times when the trends of securitization have changed from '*Can this class of assets class be securitized*?' to '*What class of assets cannot be securitized?,*' and when securitization has definitely become one of the more vivid debt capital market segments, with more and more diversified asset classes and with a broader and broader investors base, securitization is surely on the way to taking the role of a powerful financial tool for banks and lenders to solve the unavoidable problems of non-performing loans.

The inaugural deals that were made in a number of European jurisdictions in 2006, the expectation of more transactions in the pipeline, as well as the growing debates in the financial, accounting and legal professions as to the upsides and downsides, the gains and the risks of NPLs securitization prove that this trend shows no sign of letting up.

Naturally, and as outlined above, sponsors of NPLs' securitizations will definitely struggle on the way to a successful deal, having to appropriately balance the risks and rewards particularly associated with this asset class. In addition to the risks and obstacles inherent in any securitization, NPLs-backed structures will also have to tolerate uncertain cash-flows, an extreme reliance on the servicing of the pool, and a high exposure to real estate risk, but they may also contain the potential for high yield and appropriate remuneration for the various participating entities.

Also, certain specific legal matters existing in the context of these transactions may raise important issues that need to be appropriately tackled. Because the

servicing of the assets is (in contrast to what happens in 'standard' securitization structures) effectively transferred to a third-party, who is not the originator of the loans, data protection and confidentiality matters come more expensible into play. This requires extreme care in dealing with the personal data of the borrowers and, in particular, in obtaining all necessary governmental and administrative authorizations for access to and handling such data.

Also, since a significant number of loan resolutions may end up with the acquisition (for subsequent resale) of the assets serving as collateral for the securitized loans (notably real estate properties), a number of real estate related tax matters need to be accommodated in the structure. In fact, taxes triggered by the acquisition and/or disposal of real estate properties or by the creation of security thereon will represent additional costs which, in light of the exit strategies used by the servicer, may end up being significant the same reasoning applies to Land Registration fees and other similar costs. Therefore the financial structure of the transaction must also take these liabilities and contingencies into due account.

For the same reasons, real estate related legal issues, such as those raised by tenancy law or environmental law, may also raise difficulties and of course require the transaction documentation to not only properly disclose any potential associated risks, but also to clearly allocate responsibilities for any potential losses, so that investors are not surprised by unexpected bond defaults.

Having said this, and as demonstrated in the previous pages, the market is already aware of the legal 'technologies' available to allow for the smooth implementation of asset-backed structures involving NPLs. Also, recent economic stagnation in most of the European countries means that there is plenty of 'fuel' to boost the securitization of NPLs. There are certainly risks that are particularly associated with this sector but we consider that there are also rewards which merit that this asset class be properly pursued. Also, there are clear business opportunities in this sector and therefore market players would be advised to take up the challenge and to seize them.