Box 7
Recent developments in pricing of non-performing loan portfolio sales

Prepared by Maciej Grodzicki, Julian Metzler and Edward O'Brien

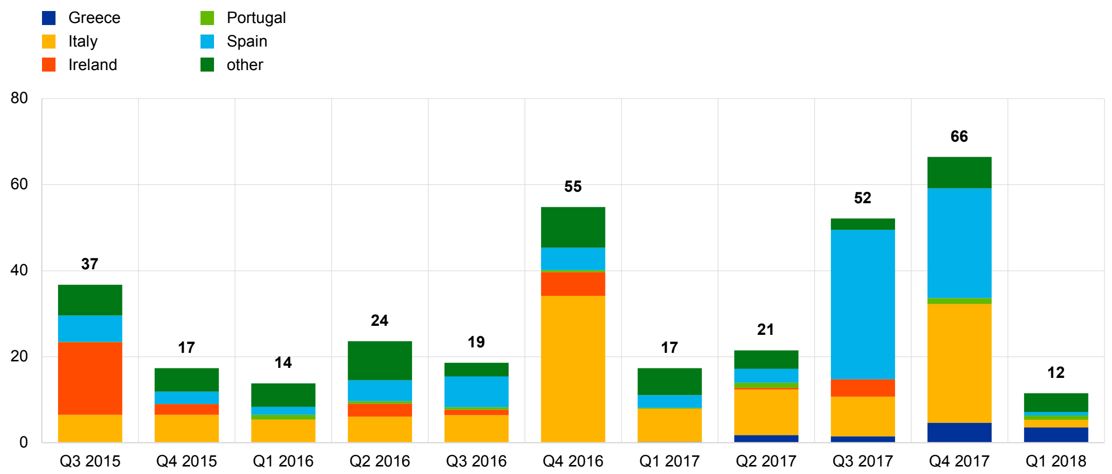
The market for NPLs in Europe has become more active in recent years. The total amount and volume of transactions has continuously increased in the last three years (see **Chart A**), although part of the increase in volumes can be attributed to just a few large transactions. Italy and Spain account for the majority of the market turnover. However, the geographical scope of NPL markets in the euro area has also widened, with transactions starting in Greece in 2017 and in Cyprus in 2018. At the same time, market activity in more mature NPL markets, such as Ireland, has weakened against the backdrop of a diminishing supply of NPLs.

Chart A

Transaction volumes in secondary markets for NPLs are on the rise

Total gross book value of traded NPL portfolios in the euro area

(Q3 2015 – Q1 2018; EUR billions)



Sources: KPMG Debt Sales Monitor and ECB calculations.
Notes: €115 billion of transactions were reported as ongoing at the cut-off date of this FSR. Numbers above bars indicate total European transaction volumes for each quarter.

Data on actual NPL portfolio sales can be brought to bear to estimate the rates of return demanded by investors in recent transactions. The transaction prices reported for around 30 portfolio sales[49] were matched with supervisory data on provision and collateral coverage reported by seller banks at the time of the transaction to estimate the spread between the sale price and the net book value at which the seller held the NPLs. To account better for the differences in collateralisation levels of various portfolios, the internal rate of return (IRR) achieved by the NPL buyers was also estimated. In doing so, it is assumed that the NPL investor will recover the book value of collateral, taking on average four years until the recoveries materialise. Moreover, it is assumed that the unsecured part of the NPL portfolios will produce recoveries of 5%.[50]

Contrary to anecdotal evidence, the data do not show that increased market activity is accompanied by a tightening of the spreads between the book and market values of NPLs. These spreads are to a large degree explained by market frictions and information asymmetry, which give rise to a market scenario in which investors take advantage of market power. Earlier ECB analysis placed these spreads in the region of 20-40% of the gross book value of NPLs in high-NPL euro area countries.[51] Recently observed sale prices corroborate these estimates and show that these spreads have not declined substantially over the last few quarters (see **Chart B**). The dispersion of the estimated spreads remains wide.

49 This bespoke dataset was collected from several market sources, including in particular Banca IFIS Market Watch, KPMG Debt Sales Monitor and individual bank announcements. It covers transactions related mainly to commercial real estate and corporate loan portfolios.

50 This is broadly equivalent to the assumption that NPLs are valued on a gone-concern basis, that is, the recoveries would be derived mainly from collateral and that the unsecured part would generate very limited cash flows. As data on recoveries from unsecured corporate loans are not available, the assumed 5% recovery rate on the unsecured part is based on market pricing of unsecured consumer loans.

51 See Fell, J., Grodzicki, M., Krušec, D., Martin, R. and O'Brien, E., "Overcoming non-performing loan market failures with transaction platforms", *Financial Stability Review*, ECB, November 2017, pp. 130-144.

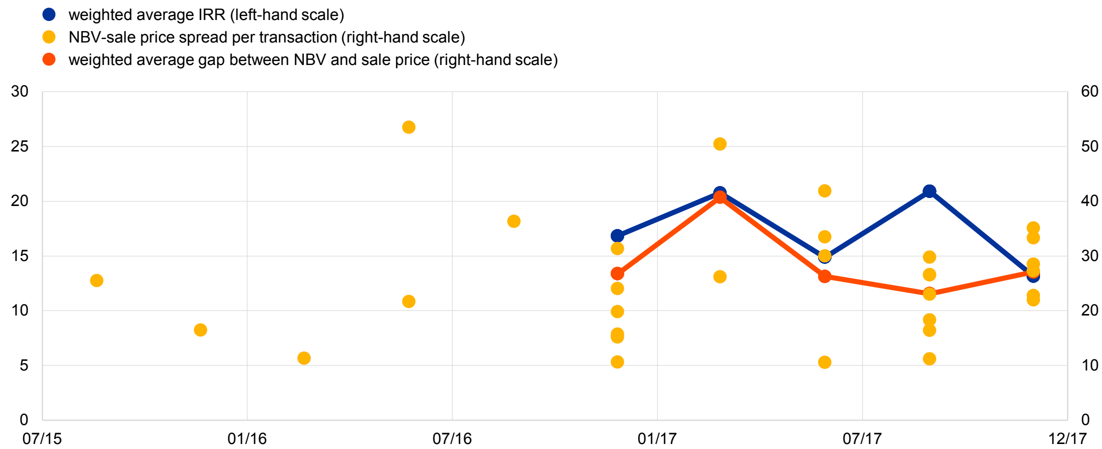
NPL transaction prices do not imply any clear downward trend in IRRs. Pricing is consistent with average IRRs within a range of 13% to 20% over the past few quarters (see **Chart B**). As with spreads, estimated transaction-level IRRs are widely dispersed. The interquartile range of the IRR of transactions executed in 2017 lies between 9% and 19%. However, these results may not be fully conclusive, owing to three types of limitation. First, the sample of transactions is small and possibly not fully representative. Second, detailed data on the composition of NPL portfolios sold is not available, and it is therefore simply assumed that these portfolios are homogenous with the portfolios retained by banks. Finally, it is assumed that the time needed to complete recoveries is constant for all portfolios and across time.

Chart B

Pricing of NPL sales does not show a clear improvement over time

Estimated IRRs earned by NPL buyers and spreads between net book value and sale price

(Q3 2015 – Q4 2017; percentages, spread in percentages of gross book value)



Sources: KPMG, Banca IFIS Market Watch, bank announcements and ECB calculations.
Notes: NBV – net book value. Averages are not calculated prior to the fourth quarter of 2016 owing to the very limited number of observations.

From a policy perspective, these results support the view that the secondary market for NPLs continues to be afflicted by several types of market failure. The increase in market turnover has not translated into substantially lower bid-ask spreads. This further reinforces the case for determined implementation of the European Council's NPL Action Plan and for accompanying national reforms that would facilitate debt recovery, speed up insolvency processes and increase transparency around the value of NPLs.