

## The PFE Interview: Kingsley Greenland, The Debt Exchange (DebtX)

### European banks that tackle bad loan problem early seen in stronger position compared to other national counterparts

European banks that have sold off bad loans, even if the balance sheet loss is painfully large, are in a stronger position compared to counterparts that have delayed doing this, and the current takeover of Germany's HVB Group by Italy's Unicredito is evidence of this, says the head of a leading international loan sale platform.



Kingsley Greenland says NPL deals will get smaller as Basel II approaches.

Kingsley Greenland, Chief Executive Officer of the Boston-based Debt Exchange (DebtX), told *PFE* in an interview that it makes no sense for banks to continue a state of denial over distressed loans, i.e. credits that are sub- or non-performing. German banks facing this problem are in roughly the same stage of the cycle as US banks 15 years ago and Italian banks in the early part of this decade. Both banking systems are stronger for having tackled the problem.

"A bank's job is to lend money and extend credit and it is not the most efficient place to work out bad loans," Greenland told *PFE*. "Of course you don't want to give all the profit away but managing distressed debt on the balance sheet is not the business you are in ... Move the bad assets out quickly and concentrate on making money. The pain is more severe but if you wash it through, experience shows that both your business and the economy in general will recover more quickly as a result."

Founded five years ago, DebtX is an Internet-based marketplace for loans, allowing individual credits or portfolios to be shown to accredited investors. Active in Europe for more than three years, DebtX is sourcing loans in Germany and Italy through various channels. The exchange has 3,500 accredited investors, the vast majority in the US. Some 175 financial institutions have sold loans via its market.

At the IMN NPL conference last week Greenland predicted that direct loan sales will be an integral part of German banks' active portfolio management in five years' time, and 100 institutions are likely to participate on the buy side for each offering. DebtX has just sold a small €10m portfolio of German loans, and over 60 institutions had looked at the assets. As well, more innovative balance sheet asset management will ultimately lower the cost of credit for borrowers.

The forecasts are based on US experience from the early 1990s, he told *PFE*. After the Savings and Loan crisis, bad loans from the financial system were taken over by the government-backed Resolution Trust Corporation (RTC). They were subsequently transferred back to the private sector in some form.

"It looked a lot like what has happened in Germany in the last two years, and in Italy in 2000 and 2001" he told *PFE*. "It was a crisis, and the US said the banking industry would be crippled if nothing was done. Banks were not going to earn their way out of it - at least not quickly." Because Italy in the late 1990s offered its banks a five-year period to spread the balance sheet impact of marking down poor quality assets, the nation's banking system had, in effect, dealt with the major part of its NPL problem within six years. "Now loan sales are not considered a bad thing in Italy. They are considered a normal part of the process," he said. Unicredito has been one of the banks that tackled its problem at the time. Because it has emerged strengthened, it has been able to make a takeover bid for a German bank still struggling with an underperforming asset base.

Greenland said the appetite for European assets from US institutional investors is very high, focused on finding yield and diversifying out of dollar assets. Exchanging NPLs through a marketplace means smaller portions of balance sheets become fungible - alongside the large well-publicised portfolios currently being sold in blocks by European banks to foreign investors. He predicted that more than 10% of German banks will have executed such a loan sale by 2010, that individual sales will range from as low as €3m up to €250m, and that total annual face value of German bad loans sold will be around €3bn annually. Commercial property loans are likely to attract the majority of exchange activity, conveyance documents will be standardised, and execution costs will drop significantly.

Even if the latest announcement from US regulatory authorities indicates a delay of Basel II new capital adequacy guidelines until 2007, Greenland sees the approach of the new, more precise risk-based pricing environment as increasing business for DebtX. Since banks will be required to match their overall equity capital more precisely to the risk profile of their asset base, they will ultimately incur no additional negative impact from downgrading the status of a loan prior to sale. "Basel II is all about marking an asset to market," he noted.

"By having an effective secondary market, European banks will be able to price an asset on their balance sheet according to what they know they can sell it for," he said. "The more liquid you make any instrument, the better you can price it. It makes for deeper pools of capital."

Greenland sees 2005 marking the beginning of the end of the "super-size transaction" in NPLs, and predicts focused buyers will emerge, with the next two years dominated by smaller volume NPL deals. If Germany follows the pattern of the US, the years 2008-2010 should see the emergence of a secondary market for performing loans, he added. pfe