Role of Private Sector Investors in Resolving NPLs

By Ellis Short

Throughout Asia, there is a tremendous volume of non-performing loans. There are many estimates of the total size, but somewhere in the neighborhood of $2 trillion in principal balance, give or take a few hundred billion, is a decent guess. It will be necessary for each of the various countries to significantly reduce or resolve these NPLs before achieving full economic recovery. Private equity capital is necessary to accomplish this, particularly in the early phases of the resolution process. I thought it might be helpful to explain the role of investors like Lone Star in the resolution process, and the selection criteria Lone Star uses to determine where to allocate its capital.

After an economic shock, governments typically form an entity to begin to deal with the NPL problem such as the RTC in the U.S., the RCC in Japan, KAMCO in the Republic of Korea, and the four AMCs in the People's Republic of China. A common first reaction is to hope for a relatively painless solution that will resolve the NPL issue without causing too much loss to the banks. Securitization is a commonly pursued potentially painless cure-all.

In Japan, for example, it was hoped that the tremendous amount of private wealth in the country would help to resolve the NPL problem by buying securities backed by the NPLs at high prices. Unfortunately, that was not a viable solution because the assets, in their raw state, were generally not securitizable. General asset quality was poor, lending discipline in the long post war expansion had become weak, cash flow within the NPL portfolios was negligible, and there were no established, rated servicers to rely on for collections.

Lone Star and a few others are effectively achieving this same desired result – matching the in-country private wealth with the NPL problem, in a different way. This is done by buying large pools of NPLs, which are then worked out one at a time and ultimately sold to local investors one at a time.

To help clarify, I'll use the real-life example of a loan Lone Star purchased in the past. The loan was secured by an obsolete property located in a good neighborhood in central Tokyo. The collateral value of the property was much less than the loan amount. Lone Star's price for the loan was less than the collateral value. The borrower had been paralyzed by its debt for several years as there was no hope of ever paying it off. After Lone Star purchased the portfolio, its affiliated servicer negotiated with the borrower, and the property was sold with all sales proceeds going to Lone Star. The remainder of the borrower's debt was forgiven. The buyer of the property, a small local developer, demolished the existing obsolete building, built six houses on the site, and sold them. In the end, everyone's position was improved: the bank fully disposed of the bad loan so that it could focus on its main business, the borrower was freed from his over leveraged situation so that he could focus on productive pursuits, jobs were created to build the houses, and the reasonably priced new houses attracted people back into central Tokyo.

This is the same process that occurred in the US during the early 1990s. Private capital performed the early part of the cleanup. After the worst of the NPLs had been restructured, the capital markets could then begin to finance the industry through REITs and securitizations, which then facilitated the final stages of the recovery.

This asset by asset resolution process performed by private equity investors in the early stages of a given country's recovery is a critical part of the recovery cycle. It is difficult, time consuming, human resource and systems-intensive work. It is not glamorous, but achieves the desired result slowly and steadily. I don't believe that this step can be skipped.

I'm frequently asked what criteria Lone Star utilizes to determine where to invest. The first consideration is the size of the NPL problem. It is very expensive to set up an operation in a new country. This is a very local business, and a large local operation with adequate infrastructure/systems, etc. is necessary to be successful. Lone Star wouldn't set up such an operation unless it believed it could invest a significant amount of capital in that country.

The second consideration is the government reaction to the NPL problem. Governments can apply pressure on the banks to resolve the NPLs, or provide incentives (such as the new AMC law in Taipei,China) to do so. Governments can also nationalize bad assets and sell them themselves (such as KAMCO and KDIC in the Republic of Korea). On the other hand, governments can impede the recovery process with the wrong kind of activity. Lone Star needs to assess whether or not a county's administration will create an environment that will allow it to invest a meaningful amount of capital.

Lone Star also considers the state of creditors' rights and the legal system in each country of potential investment. This is obviously critical to the ability to effectively work out the assets, and after resolution, repatriate the capital back to the fund investors.

Based on these criteria, Lone Star is currently focused on Japan, Republic of Korea; People's Republic of China; and Taipei,China. Lone Star Fund IV, a $4.2 billion fund, is currently being invested. Approximately 85% of the fund is expected to be invested in Japan and Asia.