INSOL International

Assignment of Non-Performing Loans (NPLs) – Main Challenges in Brazil

November 2016

Technical Series Issue No. 34

Assignment of Non-Performing Loans (NPLs) - Main Challenges in Brazil

INSOL International
6-7 Queen Street, London, EC4N 1SP
Tel: +44 (0) 20 7248 3333 Fax: +44 (0) 20 7248 3384

Acknowledgement

INSOL International is very pleased to present a technical paper titled “Assignment of Non-Performing Loans (NPLs) - Main Challenges in Brazil” by Roberto Vianna do R. Barros and Jorge Barbieri Gallo of Campos Mello Advogados, Brazil.

In recent years, Brazil has experienced an increase in the availability of credit, raising the national purchasing power mostly by means of the use of credit cards, consumer loans or auto-financing. Due to the current macroeconomic scenario it has also seen an increase in the default rate and a corresponding increase in the stock of NPLs in the portfolios of financial institutions throughout the country. These financial institutions are increasingly seeking to assign the NPLs with the intention of clearing their balance sheets and this growing market for NPLs has attracted the attention of both international and local investors, whose core business is the purchase, management and negotiation of this type of asset at a discount rate.

This paper examines the current status of the market for NPLs in Brazil and the constraints imposed on it by the applicable regulations and legislative requirements for both assignments of and after-sale management of NPL portfolios. It makes comparison with two other international markets: firstly, the US, which is considered to be the most developed market for NPL transactions and secondly, Spain, a less developed market with some similarities to Brazil.

INSOL International sincerely thanks Roberto Vianna do R. Barros and Jorge Barbieri Gallo for this detailed analysis and for writing this excellent technical paper.

November 2016

Assignment of Non-Performing Loans (NPLs) - Main Challenges in Brazil

By Roberto Vianna do R. Barros and Jorge Barbieri Gallo*
Campos Mello Advogados

I. Overview

Over the past few years, the Brazilian market of Non-Performing Loans (NPLs) has been developing and attracting the attention of both international and local investors. During this period, Brazil has experienced an increase in the availability of credit, raising the national purchasing power by means, mostly, of the use of credit cards, consumer loans or auto-financing. Due to the current macroeconomic scenario, however, we are also seeing an increase in the default rate and a corresponding increase in the stock of NPLs in the portfolio of financial institutions throughout the country.

If financial institutions keep NPLs in their portfolios, this may entail adverse effects on their regulatory capital ratios. Accordingly, local banks are encouraged to pursue a way of renegotiating these NPLs with the intention of clearing their balance sheets. As a result, Brazilian financial institutions are increasingly structuring transactions in which they assign NPLs to investors, whose core business is the purchase, management and negotiation of this type of asset (i.e., distressed assets), at a discount rate.

In this paper, we review how transactions are carried out in Brazil and make comparison with two other international markets. Firstly, the US, which is considered to be the most developed market for NPL transactions. This allows us to see how the NPL market develops and how to improve deals in Brazil. Secondly, Spain, which is a market with some similarities to the Brazilian market, offering good parallels and enabling us to see where Brazil is getting it right and where mistakes may have been made.

In recent years, the U.S. NPL market has been extremely busy and remains the most active market in the world. The American financial sector has improved significantly since the depths of the combined global financial and economic crises and the market continues to be highly active and liquid. In addition, it is important to mention that loan sales are a highly popular portfolio management tool used by banks in the United States to exit under-performing, non-core and non-performing assets.

Similarly, the Spanish NPLs market has been developing and has shown a noticeable uptick between 2011 and 2012. Most of the transactions closed in those years were unsecured NPL transactions. In addition, portfolios of Commercial Real Estate (CRE) have started to be brought to the market given the reduction in yields and the expected performance. During that period, not only were Spanish banks encouraged to sell their non-core assets, but foreign financial institutions have also started to adopt a potential partial reduction of their exposures in Spain and to think about accepting discounts to their current book value, in order to achieve an earlier exit from the country and the market.

II. Macroeconomic scenario

The Brazilian market is facing one of its worst political and economic crises in history. The country has lost its rating of investment grade and its gross domestic product suffered a negative increase of 3.5% in 2015, with a negative growth also expected for 2016. Due to this scenario, increasing numbers of Brazilian companies and individuals have become insolvent. Accordingly, there is an automatic growth of NPLs in the market. In addition, the Brazilian currency has depreciated in value in comparison with other foreign currencies, making the price of local assets (including NPLs) more attractive to international investors.

In contrast, in the U.S., the financial sector continues to improve and banks are turning their focus from crisis to growth. Along with this, banks are adjusting to increasing regulation, facing higher capital requirements and responding to the call for improved shareholder value. For others, the most important thing is to resolve legacy asset quality and underperformance.

* The views expressed in this paper are the views of the authors and not of INSOL International, London.

Another good point of comparison is the Spanish economic environment. The global economy fell into recession in 2008 and the Spanish economy (like the Brazilian economy in recent years) has been severely impacted by this. Unemployment rates have risen and Spanish house prices have fallen due to a squeeze on credit and oversupply. In 2012, Spain agreed to accept a loan to recapitalize the Spanish banking sector, which helped to reverse the negative trend and expand the NPLs local market.

III. Laws and regulations

Formalities

In Brazil, there are three potential pieces of regulation that affect this market. First, there is the general rule for the assignment of rights set forth in the Brazilian Civil Code. In relation to financial institutions selling NPLs, certain resolutions and circulars from the Central Bank of Brazil also impose restrictions on this type of activity. Finally, as most of the purchasers of this type of asset are investment funds (known as investment funds in credit rights or FIDC), the applicable regulation of the Brazilian Securities Commission (CVM) is also relevant.

The Brazilian Civil Code allows creditors in general to assign their rights, provided there is no limitation arising out of the nature of the credit, the applicable laws or the contractual relationship between them and the debtor[1]. In this sense, it is always important to perform due diligence on the NPL to ensure that it is not subject to any such restriction.

It also imposes certain formalities in relation to the transaction documentation. In this respect, an assignment is only binding against third parties if it is executed through a public document or a private instrument with the indication of the place and date of its execution, the purpose of the business and a clear identification of the parties (assignee and assignor). Also, the agreement (or another document evidencing the assignment) has to be registered with the competent Registry of Deeds and Documents in Brazil.

Notice to underlying debtor

Finally, the Brazilian Civil Code also prescribes that the assignment is only valid against the underlying debtor that is notified of the assignment. It is important to stress that, unless otherwise provided for in the original agreement, the prior approval of the debtor is not necessary. The debtor has only to be notified of the assignment, by any means that is legally possible. In most cases, this creates a practical difficulty for the parties, as NPL transactions involve a significant number of underlying credit agreements (hundreds or even thousands of credit cards financings, consumer financing deals or auto financing transactions). In addition to that, the assignee is not always able to properly identify all the debtors to the credits it is selling, which poses the question of who to notify. Another important factor in this equation is the cost involved in the notification of all those parties. These issues have been creating some significant deadlocks in the market and Brazilian courts have not helped to resolve them. The courts have tended to be conservative in their interpretation of the applicable formalities because the transactions deal with consumer rights, thereby increasing the burden on the assignee.

Regulation from the CVM

Another regulatory problem that the market is facing arose from a recent change in the regulation of FIDCs by the CVM. The regulator imposed on the FIDC (or a third party hired by it other than the assignor) the obligation to keep all the documents evidencing the underlying credit. This involves a significant amount of documentation, which implies issues (logistics, costs etc.) relating to its transfer and storage. Typically, the assignor would render that service, free of charge, for a certain period of time, allowing the assignee to assume this burden within reasonable limits. Now, players in the market are trying to find alternative solutions to accommodate this in a way that generates the minimum possible impact on the deal. After many discussions with and pressure imposed by the relevant parties upon the

[1] Certain credits, as a result of their nature, may not be assigned. These credits include those arising out of alimony rights, credits that have been subject to prior assignments or ancillary rights that are serving as collateral for other obligations. Other credits may not be assigned by force of law: payroll of judges, teachers, public servants and any other credit that is not subject to attachment as a result of the law. Finally, if the parties have agreed in the underlying contractual relationship, that the rights and obligations of the agreement may not be assigned, this credit may not be subject to this type of transaction.

CVM in relation to such changes, the CVM has indicated that the assignor may continue to keep all the documents evidencing the underlying credit, provided that the assignment agreement contains clauses which imposes an undertaking upon the assignor to repurchase the credits in the event that the FIDC requests documentation evidencing the existence of the credits and the assignor is unable to provide such documentation. Further developments are expected in relation to this.

Regulation from the Central Bank

Brazilian Central Bank's regulation also plays an important role, as most of the current sellers of NPLs in Brazil are financial institutions. The Central Bank's regulations are divided into two categories: regulations relating to situations where the assignee is another financial institution and those relating to situations where the assignee is not a financial institution[2]. There are some important differences between the two transactions. First, if the assignee is not a financial institution, the assignment may not benefit from the co-obligation of the assignee (i.e., the assignee is not responsible for the default of the underlying debtor). Second, the purchase price paid by a non-financial institution may not be in installments. In this case, the payment has to be made with immediately available funds at the date of the financial settlement of the transaction. Finally, and maybe most importantly, the repurchase of the assigned credits is not allowed[3].

Repurchase clauses

This final restriction has important consequences. One of the most sensitive clauses relating to NPLs in Brazil is the possibility of the assignees' demand for the repurchase of the NPLs. Basically, upon the occurrence of certain events[4], the assignee may unwind the transaction relating to a specific credit by (a) transferring back the credit to the assignor and (b) receiving the purchase price back. As discussed above, such repurchase clauses may only be acceptable under Brazilian law in the following situations:

(i) agreements executed by and between financial institutions;

(ii) agreements executed by and between a financial institution and a FIDC regulated by the CVM; or

(iii) agreements executed by and between a financial institution and a securitisation company.

Impact of Basel III and other recent regulations

In addition to all the above, Brazil has recently adopted a set of laws and regulations to implement the so-called Basel III rules in the domestic regulatory framework. It is beyond the scope of this paper to discuss the changes promoted by Basel III, not only in Brazil, but in all countries adopting those guidelines. Suffice to say that the changes made to the regulatory capital requirements have created additional challenges for financial institutions and increased the need for creative solutions to achieve growth with profitability.

In the U.S., for instance, the challenges remain as institutions deal with significant changes in the regulatory landscape (including stress testing and the ramifications of Basel III which places additional requirements on banks with respect to the amount and quality of capital). Stress testing in the U.S. covers approximately 225 institutions (with total assets in excess of $10 billion). Comprehensive Capital Analysis and Review (CCAR) and the Dodd-Frank laws provide that banks must pass the stress tests in order to avoid regulatory sanctions or restrictions as well as to be able to increase dividend payments and/or share buybacks.

---

[2] To be accurate, the regulation of the Central Bank is three fold: (1) where the assignee is a financial institution; (2) where the assignee is not a financial institution; and (3) where the assignee is a securitisation company (*sociedade securitizadora de crédito*). The latter situation is dealt with by a specific Resolution of the National Monetary Council (CMN) No. 2686 dated January 26, 2000. Given the specialised nature of this type of transaction, we will not discuss it in this paper.
The assignment of credits by Brazilian financial institutions is generally regulated by CMN's Resolution No. 2836 dated May 30, 2001.

[3] These restrictions are generally not applicable to FIDCs.

[4] The most common examples of such events include: (a) credits: (i) resulting from fraud; (ii) arising from a legal act that fails to comply with any of the legal requirements for validity set forth in article 104 of the Brazilian Civil Code; or (iii) paid to assignor before the completion of the assignment; (b) overpayment in relation to other credits assigned under the agreement; (c) claim for refund of overpayment whenever it concerns payment of the debt in full; (d) statute of limitations or award resulting from settlement in full of the debt or debit balance in favour of the underlying debtor.

Banks outside the scope of stress testing (those with less than $10 billion in total assets) constitute the vast majority of all FDIC-insured institutions and are not immune to regulatory challenges. They have also been accessing the loan sale market as part of their strategy to address regulatory and legacy asset issues.

Capital constraints and the demand for improved return on equity (ROE) play a significant role in the institutions' strategic decisions. However, the additional requirements placed on banks by stress testing and Basel III have a negative impact on shareholder value as reflected in ROE. So, banks are increasingly focused on strategies to meet regulatory requirements, achieve growth and deliver shareholder value.

NPL transactions may help solve or at least mitigate most of these issues.

In Spain, the Financial Stability Board and the Basel Committee, in order to control certain problems of the banking and financial system including the excessive credit growth and the insufficient liquidity levels, has been adopting several measures in line with the reforms and new regulations of Basel III. By means of these measures that have been implemented, they are aiming at implementing more demanding criteria with regards to the levels and quality of capital required of banks.

The regulatory and institutional changes brought by Basel III are helping the reform and recovery of the financial sector and financial institutions in Spain, which include the clean-up of their balance sheets. Accordingly, NPL transactions may have an important role in the implementation of such measures and also in the recovery of the financial institutions in Spain.

IV. Transaction requirements in the Brazilian market

Credits subject to litigation v credits not subject to litigation

The Brazilian NPL market is typically divided in two types of credits: those that are already being collected through a judicial process (Credit(s) Subject to Litigation) and those that are not yet in that phase (Credit(s) Not Subject to Litigation). The reason for this is that, from a contractual perspective, there are different issues to be dealt with for each type of credit in the assignment agreement.

Credits Not Subject to Litigation are easier to manage. In general, the assignor agrees to give notice of the assignment to all collection companies in charge of the extra-judicial collection of the Credits Not Subject to Litigation (Collection Companies) by a certain date agreed by the parties (the Cut-Off Date). After the Cut-Off Date, the Collection Companies cease to be in charge of the extra-judicial collection of those credits, and the engagement of Collection Companies becomes the sole responsibility and at the sole discretion of the assignee. Any costs, expenses and compensation payable for all the services provided by Collection Companies up to the Cut-Off Date is usually borne by the assignor. After that, the assignee is responsible for them.

Dealing with service providers

On the other hand, Credits Subject to Litigation are more complex to manage. First, there is the matter of the service providers. The assignor has to give notice of the assignment of the Credits Subject to Litigation to all its external counsel in charge of the judicial collection of those credits (the Service Provider(s)), within a certain period of time after the execution of the agreement. The assignee has to decide whether it wants to retain such counsel as service providers on the same basis of the agreement entered into with the assignor for collection suits relating to Credits Subject to Litigation, and request them to express whether they agree or not to provide services to the assignee. Otherwise, a different arrangement has to be structured. Usually, all costs, expenses, fees and any other compensation payable to all the Services Provided up to the Cut-Off Date (including costs relating to legal and administrative procedural acts) are borne by the assignor. After that, they are borne by the assignee.

Collection suits in progress

The second matter to resolve is the control over the collection suits in progress. In general terms, the assignee assumes any collection suits (including, without limitation, search and

seizure actions, monitory actions and any other actions similar to collection suits) for the Credits Subject to Litigation brought by the assignor up to the date of the agreement (or a different date, if agreed by the parties). To this end, the assignee must request, jointly with the assignor, in a gradual manner and assessing the respective procedural stage in order to prevent procedural losses to the respective judicial collection of the credit, by filing a request for substitution of claimant, the substitution of the assignor with the assignee as claimant in any and all collection suits for Credits Subject to Litigation, or acceptance of the assignee as an assistant to the assignor in such proceedings in the event of denial of its request for substitution of claimant. Upon granting of the request for substitution of claimant, or if the assignee is required to join as an assistant, the assignee will be in charge of the defense and prosecution of the lawsuit and assume all the respective costs and awards.

If the request for substitution of claimant or the joinder of the assignee as an assistant is denied, certain alternatives may be implemented. The most common solution is for the assignor to assume responsibility for all procedural acts relating to the lawsuit, being reimbursement by the assignee of any expenses incurred in connection with such lawsuit. In this case, the assignor agrees to (i) comply with any instructions and decisions transmitted by the assignee until the latter may actually assume the prosecution of the respective claims so as to preserve the relevant Credits Subject to Litigation during the transition period and (ii) grant a power of attorney to the assignee, whenever the assignee is required to take measures on behalf of the assignor for defense of the credits. Another alternative is for the assignor to request the return of the Credit Subject to Litigation, pursuant to a repurchase provision in the agreement.

Transfer of information

Thirdly, the parties have to resolve how to transfer the information relating to all claims in progress at that time. Usually, the assignor agrees to transfer to the assignee, on a final basis and by electronic means, all information that may be in its possession relating to the procedural status of the collection suits under the assignment. Until the completion of that process, the assignee may have monitored web-based access to the assignor's case control system, so that the assignee may obtain any updated procedural information required for its assumption and monitoring of lawsuits relating to Credits Subject to Litigation.

Current debate on interest rates

Finally, it is important to mention that there is a discussion occurring before Brazilian courts that may have a significant impact on this type of transaction. Brazilian laws and regulations establish a ceiling for interest rates charged by non-financial institutions in Brazil. It is generally accepted that this limit is 12% per year. Financial institutions are not bound by this cap and usually charge interest at a much higher rate, in particular for individuals (e.g., through credit card and consumer financing)[5]. Some courts have decided that, if a financial institution assigns a credit to a non-financial institution, the interest charged by the assignee should be limited to the ceiling described above (at least from the date of the assignment). These decisions not only violate one of the main principles of the Brazilian legal system, which protects a transaction that was perfected in accordance with the law at the time it was concluded, but jeopardize the entire NPL market in Brazil. In our opinion, a transaction that was validly concluded between the parties at the time of its execution should continue to be considered valid if transferred to a third party.

V. Conclusion: lack of players in Brazil – opportunity for foreign investors

One of the challenges faced by the Brazilian NPLs' market is the lack of players. Although the market has a great potential to expand in Brazil, there are only a few players participating actively in this market, both on the sale and the purchase sides. Such a scenario creates a certain dependence among the existing players to foster and promote the market.

[5] According to the Central Bank of Brazil, the interest rate for credit card financing in Brazil may reach 798% per year, being the average interest rate at 400% per year. (http://www.bcb.gov.br/pt-br/#!/r/txjuros/?path=conteudo%2Ftxcred%2FReports%2FTaxasCredito-Consolidadas-porTaxasAnuais.rdl&nome=Pessoa%20F%C3%ADsica%20-%20Cart%C3%A3o%20de%20cr%C3%A9dito%20rotativo&parametros='tipopessoa:1;modalidade:204;encargo:101')

In the US, for instance, sellers include money centres, regional and community banks, specialty finance, CMBS trusts, Government agencies, and foreign banks (for example the European banks that have made U.S. loan portfolio divestments successful, since the onset of the global crises). Buyers have included a diverse set of U.S. and global strategic investors, as well as distressed and opportunistic buyers.

In Spain, the market is not as diversified as in the US, but is clearly more competitive than Brazil and may serve as an example of what could be achieved here in the mid-term. Santander, the largest financial institution in the country, takes a leading role in the unsecured market by leading the largest unsecured and secured portfolio transactions. As well as BBVA that has become increasingly active in the debt sales market and one of the most active players in the Spanish market as a whole, other notable participants include Caixabank, Bankia, Banco Sabadell, Banco Popular. As main assignees, it is important to mention the interest of larger overseas investment funds, such as Lindorff and Centerbridge.

In conclusion, despite of all the current economic and political uncertainties surrounding Brazil's future, this may be a good time for a foreign investor to start its business in this market. It will face low competition, with an incipient market, a high demand for purchasers, as the stock of NPLs has increased dramatically over recent years and attractive prices, in particular as a result of the strong devaluation of the Brazilian currency.

AlixPartners LLP
Allen & Overy LLP
Alvarez & Marsal
Baker & McKenzie LLP
BDO LLP
BTG Global Advisory
Cadwalader, Wickersham & Taft LLP
Chadbourne & Parke LLP
Clayton Utz
Cleary Gottlieb Steen & Hamilton LLP
Clifford Chance LLP
Conyers Dill & Pearman
Davis Polk & Wardwell LLP
De Brauw Blackstone Westbroek
Deloitte LLP
Dentons
DLA Piper
EY
Ferrier Hodgson
Freshfields Bruckhaus Deringer LLP
Goodmans LLP
Grant Thornton
Greenberg Traurig LLP
Hogan Lovells
Huron Consulting Group
Jones Day
Kaye Scholer LLP
King & Wood Mallesons
Kirkland & Ellis LLP
KPMG LLP
Linklaters LLP
Morgan, Lewis & Bockius LLP
Norton Rose Fulbright
Pepper Hamilton LLP
Pinheiro Neto Advogados
PPB Advisory
PwC
Rajah & Tann Asia
RBS
RSM
Shearman & Sterling LLP
Skadden, Arps, Slate, Meagher & Flom LLP
South Square
Weil, Gotshal & Manges LLP
White & Case LLP