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WHAT ATTRACTS INVESTORS TO DISTRESSED ASSET MARKETS?

Key Pillars for Private Investors to Participate in Market Development

Marta Mueller and Fernando Dancausa

Schweizerische Eidgenossenschaft
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Abbreviations

AMC	Asset management company
ARCs	Asset reconstruction companies
BCBS	Basel Committee for Banking Supervision
DA	Distressed asset
DARP	Distressed Asset Recovery Program
EU	European Union
EMDEs	Emerging market and developing economies
FCI	Finance, Competitiveness and Investment
GFC	Global financial crisis
ICRs	Insolvency and creditor rights
IFC	International Finance Corporation
NBV	Net book value
NPLs	Nonperforming loans
SMEs	Small and medium enterprises
SPVs	Special purpose vehicles

Definitions

Corporate loan	A loan provided to a company (or corporation) to finance business activities, such as, inter alia, capital investments, expansion, or working capital.
Consumer loan	A loan taken by an individual for personal use, typically to finance the purchase of goods or services. This type of loan is generally repaid with regular installments over a specific period. It does not include home mortgage loans, which are considered a separate asset class.
Collection agency or local servicer	A third-party company that is used by creditors or lenders to recover funds that are due or past due.
Days past due	Days elapsed since a borrower first missed an interest or principal payment.
Distressed asset	An asset for which the borrower is showing significant or increasing risk of default. The term includes all classes of credit (consumer, small and medium enterprise, corporate, and mortgages) as well as foreclosed assets and defaulted bonds and securities. The term includes nonperforming loans (NPLs) as well as loans that may not meet the definition of NPL set by the regulator but for which the borrower is experiencing financial or operational difficulties and may be unable to meet repayment obligations in the future.
Nonperforming loan (NPL)	Any loan for which principal or interest is more than 90 days past due or is unlikely to be paid. In addition, NPLs include all loans considered impaired under the applicable accounting framework or defaulted under the applicable prudential framework.a It should be noted that the NPL definition in any country is usually established by the financial sector regulator and can differ from the BCBS definition.
Net book value (NBV)	The gross book value of the loan net of specific provisions.
Retail mortgage	Loan provided to individuals from financial institutions for the purchase of a home or residence.
Small and medium enterprise (SME) loan	A type of business loan specifically designed for SMEs to finance various business needs, such as covering operational costs, expanding operations, or investing in new equipment. These loans can be either secured or unsecured, with secured loans covered by a guarantee or collateral.
Secured/ collateralized loan	A loan for which the borrower or a third party creates a security right over an asset (collateral) in favor of the lender. This asset may include real estate as well as movable assets, from tangible to intangible assets. If the borrower defaults on the loan, the lender can enforce the collateral to recoup its losses on the loan.
Unsecured loan	A loan that is not backed by any collateral or asset. The lender relies solely on the borrower's creditworthiness, financial strength, and ability to repay the loan. If the borrower defaults, the lender cannot seize any specific asset to fully or partially recover the debt.

a. This is the prudential definition proposed by the Basel Committee for Banking Supervision, "Prudential Treatment of Problem Assets—Definitions of Non-performing Exposures and Forbearance" (Basel, Switzerland: BCBS, April 2017), para. 24.

01.

PREFACE

This note examines the process of development of distressed asset markets and identifies selected critical factors, or "pillars," that are key for attracting private investors. The ultimate objectives of the note are to (a) provide policy makers with a simple conceptual framework for assessing the level of development and attractiveness of their market to private investors; (b) assist in the identification of market characteristics, regulations, or laws that prevent the development of a market or that make market development more complicated, uncertain, or costly; (c) identify potential reforms needed to support market development; and (d) broadly inform stakeholders' awareness and knowledge of the benefits and key features of distressed asset markets. The note is accordingly aimed at policy makers, financial regulators, financial institutions, investors, and debt collection agencies, as well as legal practitioners and financial sector development specialists. Because of its emphasis on the initial stages of development of a market, the note targets emerging market and developing economies in which distressed asset markets are yet to flourish.

The term "distressed asset markets" considers all classes of credit (consumer, small and medium enterprise, corporate, and mortgages) that are sold either as portfolios or as credits to a single borrower. Although a prudential definition of nonperforming loans (NPLs) exists, this note uses a broader term—"distressed assets"—which also includes written-off loans as well as loans for which the borrower is showing increasing risk of default and for which the lender considers full repayment unlikely. These loans may have not yet been classified as NPLs under accounting or prudential definitions.

Although distressed asset markets can involve multiple types of sellers, this note focuses primarily on distressed assets sold by regulated financial institutions, including banks, since they are of the most concern to regulators with a commitment to financial stability. Similarly, although this note may refer to foreign investors in distressed asset markets, it should be emphasized that markets can and do develop without the presence of foreign investors and their participation in a market is not a prerequisite for development.

This note was prepared by Fernando Dancausa (senior financial sector specialist, Finance, Competitiveness and Investment (FCI), World Bank) and Marta Mueller (distressed asset expert and international consultant, Distressed Asset Recovery Program (DARP), International Finance Corporation (IFC)) on the basis of their experience on recent joint World Bank Group projects focused on the creation and development of distressed asset markets, including Financial Sector Assessment Programs (FSAPs). The authors are grateful for the insightful comments of peer reviewers Zuberoa Mainz (principal investment officer, Financial Institutions Group (FIG) Middle East and North Africa), Johannes Raschke (senior investment officer, DARP), Ezio Caruso (senior financial sector specialist, FCI), Anica Nerlich (financial sector specialist, FCI), and Sergio Muro (financial sector specialist, FCI). The authors also acknowledge the contributions of Marta Sanchez-Sache (DARP global head, IFC), Matina Deen (operations officer, IFC), and Marcos Gomez Sierra (investment officer, DARP). The note was cleared by Adel Meer (acting director, Non-Banking and Alternative Finance Department, Global Sector Manager—Financial Inclusion FIG), Florence P. Boupda (manager, FIG), and Harish Natarajan (practice manager, FCI). A special acknowledgment goes to our donor partner, the Swiss State Secretariat for Economic Affairs, for their contribution and unflagging support in the development of this note.

> “Developing a distressed asset market requires the interaction of multiple factors and stakeholders, sometimes with opposing interests.

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EXECUTIVE SUMMARY

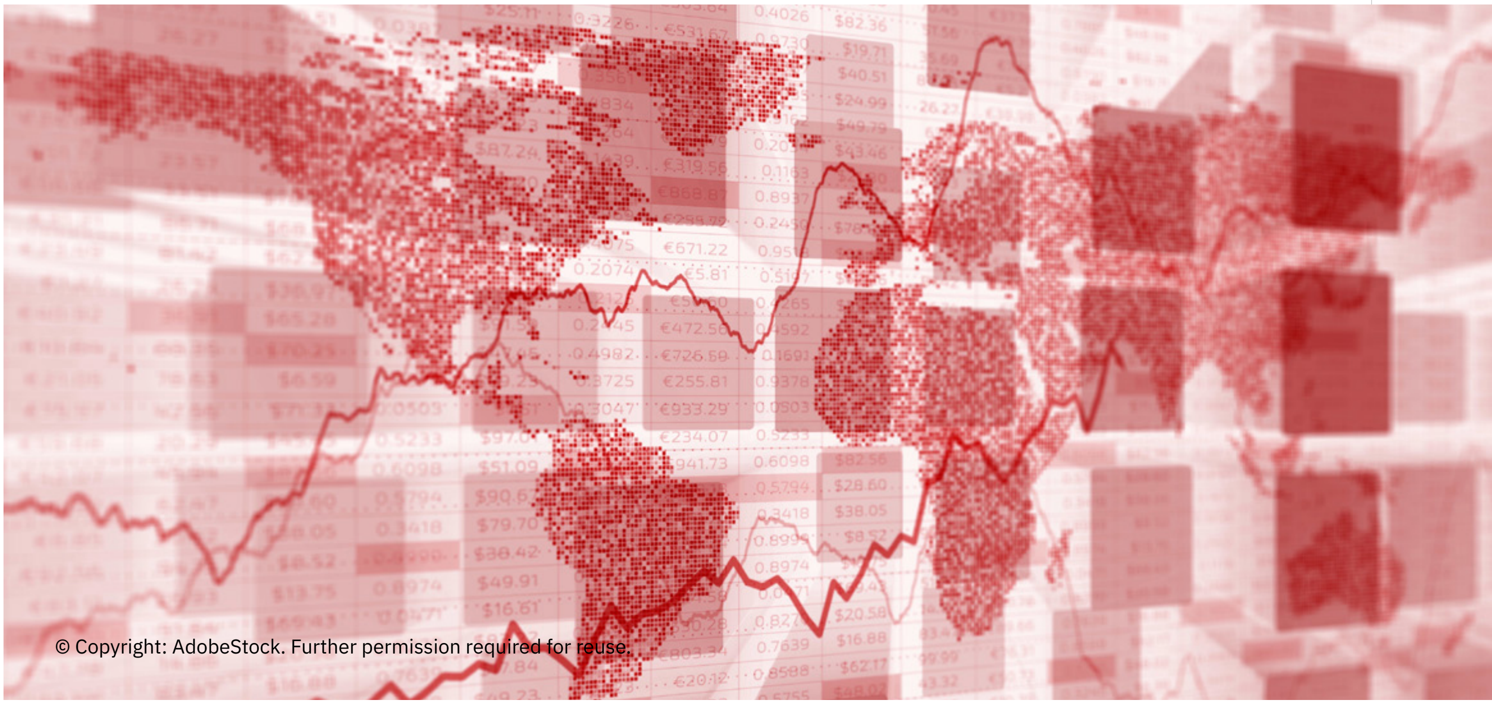
Nonperforming loan (NPL) sales have been placed at the forefront of NPL resolution strategies over the past two decades. After the 2008 global financial crisis (GFC), high NPLs in advanced economies triggered the need to optimize and further expand distressed asset markets, especially in western Europe, so that financial institutions could off-load distressed assets to specialized investors. In economies with dynamic markets, it is now possible for financial institutions to easily dispose of all types of loans, both performing and nonperforming, contributing to balance sheet management, market liquidity, and improved capital ratios. For these reasons, in developed markets, numerous laws, regulations, and guidelines have been issued in recent years with the objective of further developing distressed asset markets and lowering barriers to entry for both investors and credit servicers.

Financial institutions in developed markets can usually rely on multiple tools in addition to sales to identify, prevent, and resolve distressed assets, including early warning systems, early transfer of distressed loans to specialized departments, and enhanced recovery techniques. Many of these tools, but most importantly sales, are often underdeveloped or absent in emerging market and developing economies (EMDEs), constraining financial institutions' ability to manage NPLs (and capital) and limiting the options of borrowers—both individual and corporate—to restructure their debt. Where distressed asset markets are underdeveloped or absent, financial institutions' options are often limited to on-balance sheet management or, when provisions are sufficient, write-offs. Even where individual and corporate insolvency legislation exists, borrowers are often unfamiliar with its use or discouraged by its perceived complexity. Aware of these limitations, many regulators in EMDEs have increasingly focused on developing and enhancing the use of distressed asset resolution tools, including sales, to contribute to financial stability as well as encourage and support borrower rehabilitation.

Developing a distressed asset market requires the interaction of multiple factors and stakeholders, sometimes with opposing interests. In hindsight, acute economic and financial stress has often been the driver behind the development of markets, as observed in eastern and southern Europe following the GFC, as well as in Asia following the Asian financial crisis. In both cases, a sudden build-up in distressed assets was the catalyst for financial authorities to identify regulations or legislation that prevented market creation or expansion, resulting, at times, in the need for reforms with a range of complexity.

Even in non-crisis periods, government support is critical for market development, encompassing multiple areas. First, the authorities can ensure that a sound legal and regulatory environment exists, establishing appropriate rules regulating the transfer of assets, debt enforcement and collection, and sufficient and timely provisioning by financial institutions. Second, the authorities can also encourage the development of adequate market infrastructure, setting up public credit and collateral registries and facilitating access to credit data, legal records, and financial information by investors. Finally, the authorities can also establish a level playing field that encourages private investors, foreign and domestic, to participate in the market under equal conditions, efficiently and transparently. Reforms are likely to overlap ministerial responsibility, requiring coordinated cooperation among stakeholders.

Despite differences among countries, it has been possible to identify some common denominators (or “pillars”) that are frequently observed in more mature distressed asset markets in which private investors are active. These pillars are (a) sufficient volume; (b) ability to transfer distressed assets to a nonbank, non-licensed entity; (c) limited potential for a price gap; (d) adequate investment structure and servicing capacity; and (e) efficient insolvency and enforcement frameworks. It should be cautioned that the presence and proper functioning of most elements may not be sufficient to ensure the development of a market. In fact, a seemingly insignificant condition such as the need for borrower approval or the inability to perfect collateral can prevent a market from developing altogether, despite the presence and proper functioning of the other major conditions or pillars.



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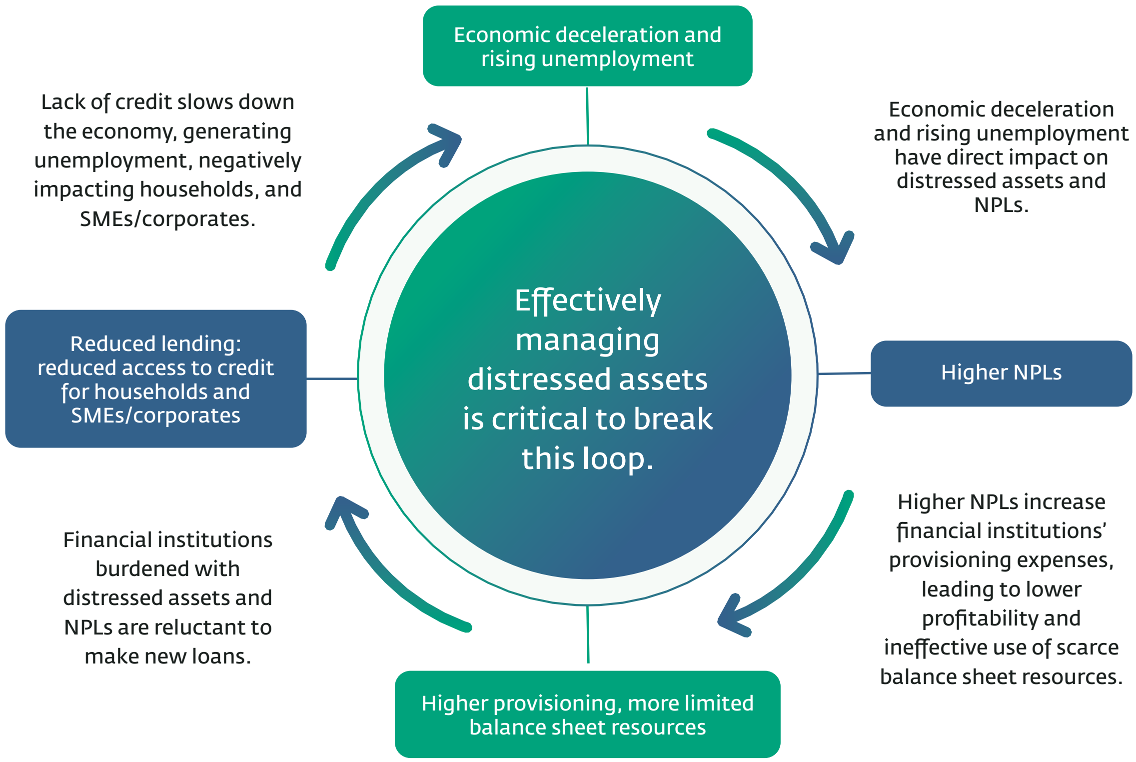
WHY IS IT IMPORTANT TO HAVE A DISTRESSED ASSET MARKET?

Elevated levels of distressed assets in an economy are often a drag on economic growth. Nonperforming loans (NPLs) on financial institution balance sheets require the creation of provisions which negatively affect capital and in turn may constrain the ability to continue lending. A decrease in lending may occur when credit is most needed, thereby reducing liquidity for private sector working capital and investment. When credit is available, it is often more expensive, further burdening borrowers. This combination of factors may result in suboptimal economic growth, cost cuts, and increased levels of unemployment, potentially leading to additional loan defaults. Unresolved distressed assets can negatively affect the greater economy further, as the assets serving as underlying collateral may be prevented from being used in productive activity (figure 1). Against this background, the ability to off-load distressed loans serves as a pressure release valve for the entire financial system.

Figure 1. The Negative Feedback Loop of High NPLs



Source: International Finance Corporation (IFC) Distressed Asset Recovery Program (DARP).
Note: NPLs = nonperforming loans; SMEs = small and medium enterprises.

Distressed asset markets permit swift distressed asset reduction through sales. Other distressed asset reduction strategies rely primarily on on-balance sheet resolution approaches, in which the financial institution retains ownership of the distressed asset and attempts recovery using the methods available, including financial and operational restructuring of the borrower, loan restructuring, insolvency procedures, enforcement, write-offs, or a combination of methods. These approaches are often preferred by financial institutions, which consider that distressed loans are better managed in-house given their more intimate knowledge of and/or their relationships with their clients. However, even in markets in which financial institutions have developed a dedicated in-house "workout" unit, creditors can benefit from the sale of distressed assets for the following reasons:

Financial

- Time value of money: Sales can generate cash liquidity for the selling financial institution faster than the process of individual asset resolution and recovery.
- Mobilization of investors: Creditors can segregate distressed assets into asset classes and approach investors with an appetite for a specific asset class, thereby maximizing both sales value and cash.
- Shareholder value creation: Sales can potentially generate a profit in those cases where the sales price is above the net book value of the

distressed assets sold; sales can also lead to an improvement in the capital position via the release of provisions.

- Unlocking new lending: If capital release is a result of sales, it can be leveraged for new lending.
- Compliance with prudential rules: Sales improve NPL and capital ratios, a reporting requirement for financial institutions.

Operational

- Business focus: Sales of distressed assets allow financial institutions to focus on their core business of lending.
- Cost reduction: Distressed asset units can be costly, requiring staff, legal, and special information technology expenditures as well as management attention.

In turn, investors specialized in the asset class have several key advantages for realizing value from their investment:

- Recovery strategies of distressed asset investors provide tailored repayment solutions for borrowers, frequently offering terms not made available by the original creditor, including a discount on principal. Amicable recovery is considered by all market participants, including banks, to be the most cost-effective and highest value recovery solution. In discussions with borrowers, distressed asset investors first try to reach an amicable solution, agreeing a realistic and sustainable repayment schedule that aligns with the defaulted borrower's current financial circumstances. At times, the investor may offer a discount on the principal. In contrast, financial institutions may be reluctant to offer discounts on the loan principal as they would result in moral hazard, particularly if an ongoing relationship with the borrower is maintained. Once a financial institution has discounted principal, a borrower could anticipate that a discount on future loans from the lender will be available again and could borrow without consideration that the full amount should be repaid. There can also be market contagion if borrowers, learning of discounts provided by the lender to other debtors, intentionally default on their loans. Nevertheless, discounts from financial institutions have been observed in a few markets. Furthermore, distressed asset investors, unlike the originating creditor, are unlikely to offer new credit to the borrower in the future.
- Recognition of distressed assets may be delayed by financial institutions and thus may lead to the wrong recovery strategy. Loan originators may be reluctant to admit to a credit gone bad and will continue to work with the borrower in situations in which the expected return does not justify the cost of recovery. In contrast, experienced investors and servicers tranche portfolios, grouping similar distressed loans and employing proven collection strategies from the outset, leading to more efficient recovery. Loans with costly recovery charges compared to returns are written off to focus efforts on loans with greater recovery potential.

The creation of a distressed asset market offers multiple benefits for the various participants, including financial institutions, distressed asset investors, debtors, and the general economy (figure 2). The creation of a market can have multiple positive effects, including improving the efficiency of the financial system, reducing credit costs, offering investment opportunities, and contributing to economic stability.

Figure 2. Benefits of Creating a Distressed Asset Market

A functioning distressed asset market allows financial institutions to actively manage balance sheets, provides an opportunity for debtors to re-establish creditworthiness, and removes distressed assets from the financial system.

Lenders

- Provides opportunities for lenders to off-load DAs, strengthening balance sheets through outright sales of distressed assets, liberating capital.
- Lenders can focus on their core business (lending).
- Markets offer a more cost-efficient means of DA management.
- In preparing portfolios for sale, banks refine early warning systems and may develop more detailed portfolio reporting.

Debtors

- Contributes to the normalization of debt obligations, avoiding, where possible, the loss of productive assets while recovering credit standing.
- Increased flexibility for borrowers: Investors are not constrained by moral hazard and can offer interest and principal discounts to borrowers to encourage repayment.
- If companies avoid bankruptcy and/or liquidation, jobs are preserved.
- Mitigate lack of liquidity if borrowers have renewed access to credit.

Regulators

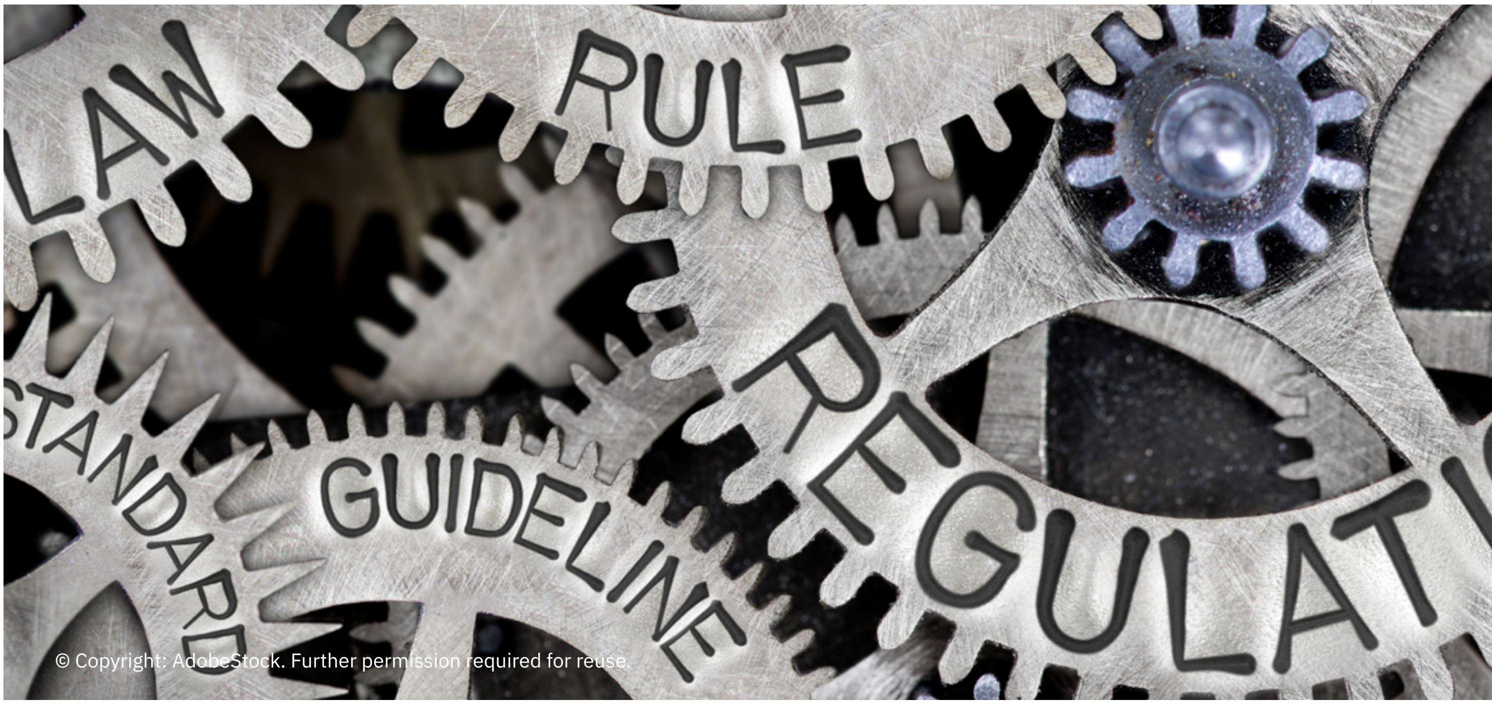
- Sold distressed assets are transferred out of the financial system when sold to non-FI investors, which brings down the NPL ratio.
- Losses arising from sales will be visible to the regulator, informing realistic provisioning.
- Increases transparency and encourages the adequate reporting of asset prices when underlying collateral is sold and current market pricing becomes part of public record.
- Fosters adequate provisioning by banks.

Source: International Finance Corporation (IFC) Distressed Asset Recovery Program (DARP). Note: DA = distressed asset; FI = financial institution; NPL = nonperforming loan.

Distressed asset markets may also have some limitations or less desired outcomes.

- In times of acute or systemic financial distress, when asset values are volatile or falling across sectors, private investors may be unwilling to put capital at risk and public authorities may need to take the lead in removing distressed loans from financial institutions. Authorities may set rules that require banks with public shareholding or banks meeting certain conditions to sell assets to a public asset management company. A condition precedent is that the government has the fiscal space to fund the purchase of assets. Government-backed interventions occurred following the Asian financial crisis in 1998 (in among other countries, Indonesia, Malaysia, and Thailand) as well as following the GFC of 2008 (in among other countries, Ireland and the United States).
- Borrowers, learning that it may be possible to negotiate a discount on loan principal following the sale of distressed assets to third parties, may deliberately default on loans in order to benefit from the potential discount (known as "strategic defaulters"). A recent example would be deliberate defaults on mortgage loans in Greece. [1]
- Large-scale enforcement and sale of loan security in falling markets may further depress market prices across sectors and asset classes, contributing to a downward spiral.

1 See Ioannis Asimakoupoulos et al., "Moral Hazard and Strategic Default: Evidence from Greek Corporate Loans" (Bank of Greece Working Paper Series 211, Bank of Greece, Athens, 2016).



04

THE ENABLING ENVIRONMENT FOR DISTRESSED ASSET MARKET DEVELOPMENT

The factors that trigger market creation can differ from market to market. Any of the following factors, or combinations of them, may be the principal catalyst for the development of the distressed asset market:

- Economic conditions: Economic downturns or financial crises can lead to a rise in distressed assets. Secondary markets for distressed assets may emerge during or after these periods as regulators seek to stabilize the financial sector by urging financial institutions to reduce troubled assets through sales. In jurisdictions where markets already exist, distressed asset sales typically increase during these periods.
- Regulatory pressure: Especially in times of financial distress but also during normal conditions, regulators may require financial institutions to reduce their NPL ratios to achieve higher capital adequacy ratios. As a result, financial institutions are incentivized to sell distressed assets to comply with new requirements (box 1).

- Creditor initiative: Financial institutions may initiate sales where possible as a proactive means of managing their balance sheet, without the intervention of the regulator.
- Government initiative: Governments play a key role in market development by ensuring that laws and regulations permit the development of the market, including among other initiatives the transfer of credit to specialized investors, the development of credit registries, improvement of enforcement and insolvency legislation, and establishment of electronic collateral registries. In times of acute financial sector distress (such as the GFC of 2008), governments may also establish centralized asset management vehicles or "bad banks" to offload significant volumes of NPLs from financial institutions.
- Investor demand for distressed assets: International investors look for investment opportunities in new markets and can stimulate the distressed asset market in EMDEs, importing additional liquidity and expertise to less dynamic markets.

Box 1. Malaysia—Danaharta

Flashback to Asian Distressed Asset Crisis:
A Regulator Incentivizing NPL Sales through Provisioning

- Danaharta Malaysia, owned by the Malaysian Ministry of Finance, was established in 1998 following the Asian financial crisis to act as the national asset management company (AMC) to buy nonperforming loans (NPLs) from Malaysian financial institutions.
- To be eligible for recapitalization by the government capitalization vehicle, Danamodal, financial institutions were required to sell NPLs to Danaharta. At the request of the central bank, all financial institutions had to submit details of NPLs above a certain threshold value to Danaharta for valuation.
- Banks had the option not to sell NPLs to Danaharta, but the regulator required that, if the bank chose not to sell, it had to make a provision for the NPL equivalent to 80 percent of the price offered by Danaharta. That is, the loan had to be written down to 80 percent of the purchase price offered by the AMC.
- At an average discount of 55 percent or purchase price of 45 (based on an original principal value of 100), if banks chose not to sell, the net book value of the NPL after applying the 80 percent provision would be 36—an incentive for some financial institutions to transfer at the offer price of 45.
- Between 1998 and 2000, Danaharta acquired US$5.2 billion (net book value) of NPLs for $2.35 billion and managed $7.4 billion in NPLs transferred from liquidated banks. By 2005, it had recovered $8 billion for the managed NPLs and lost $300 million on the acquired NPLs.

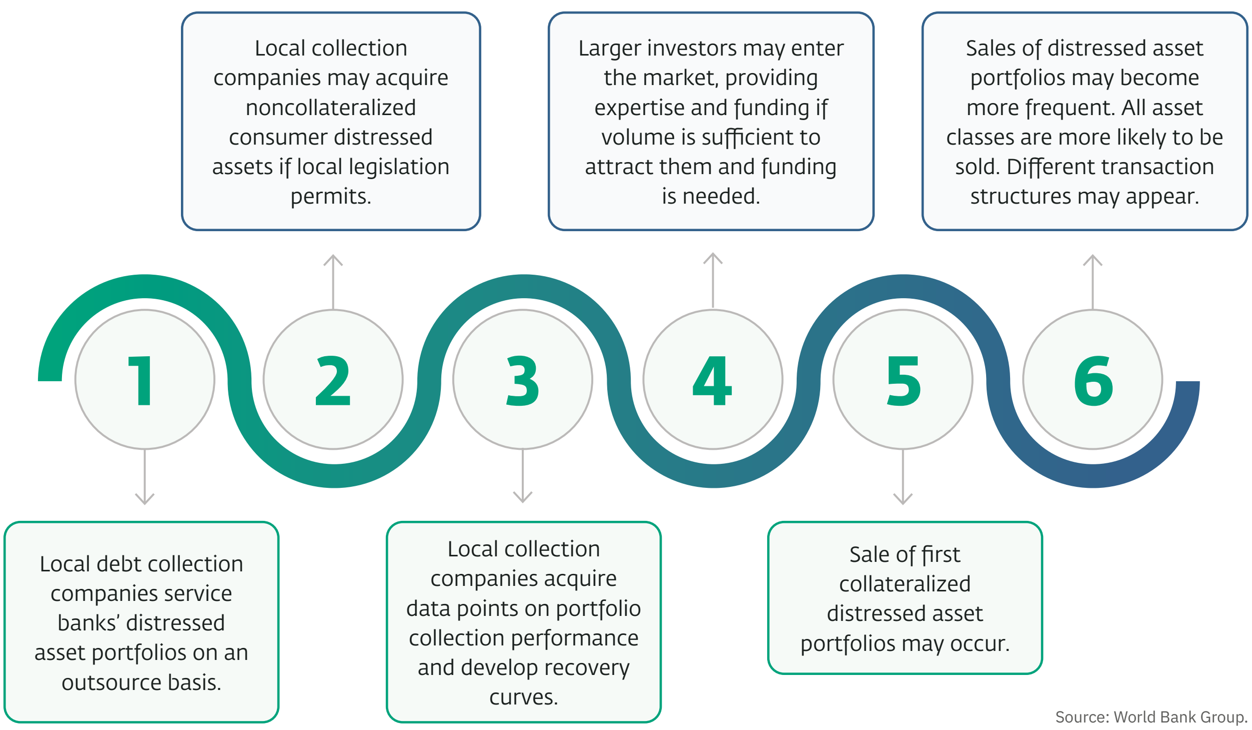
Source: Stefan Ingves, Steven A. Seelig, and Dong He, "Issues in the Establishment of Asset Management Companies" (IMF Policy Discussion Paper PDP/04/3, International Monetary Fund, Washington, DC, May 2004).
a. Mallory Dreyer, "Danaharta—Malaysia" (Preliminary Yale Program on Financial Stability Discussion Draft, Yale University, New Haven, CT, March 2020).

The development of a market is usually a progressive process (figure 3). Markets may begin with sales of heavily provisioned, older, noncollateralized consumer distressed assets to specialized local collection companies (or servicers). Other markets, experiencing a significant build-up of distressed corporate loans, may begin with more complex assets. In countries where financial institutions have been outsourcing the collection of distressed assets prior to considering a sale, local collection companies may have developed a database of portfolio collection performance, which is needed to generate recovery curves for pricing new portfolios. With historical portfolio performance data, local collection companies can price portfolios themselves, often triggering the first transactions in a market. At these initial stages of market development for lower-value distressed assets, the purchase price for consumer portfolios can usually be financed by local collection companies through internal cash flow.

After the initial development stages and depending on the asset classes under stress in each economy, the market may evolve toward the sale of collateralized distressed loans across asset classes. The transition to collateralized consumer, small and medium enterprise (SME), mortgage, and corporate distressed loans requires specialized skills to perform the necessary collateral valuation, pricing, and recovery of these assets. In addition, these larger, often higher-value exposures may require that the investor have access to substantial funding.

Below is an illustration of potential market development, although it should be cautioned that not all markets will follow the same evolution. Some markets may prohibit the sale by financial institutions of consumer loans, and thus sales can occur only in more complex asset classes, resulting in a modified market evolution.

Figure 3. Possible Evolution of a Distressed Asset Market



Source: World Bank Group.

The occurrence of corporate and larger SME distressed loans is usually a periodic phenomenon. Distressed SME and corporate loans typically spike following a period of economic or financial stress. In contrast, consumer distressed debt is usually a constant feature on most financial institutions' balance sheets, rising and falling with borrowers' personal circumstances in addition to economic conditions. In developed markets, large financial institutions often have standing agreements with investors to sell consumer loans that are more than 90 days past due, with the objective to not only maximize purchase price ("younger" NPLs command a higher purchase price) but also to manage their balance sheets. The cash generated by early sales can be recycled by financial institutions into new lending, where possible. A growing body of research suggests that reducing NPL overhang supports bank lending during recoveries.[2]

2 See John Fell, et al "Non-performing Loans and Euro Area Bank Lending Behaviour after the Crisis," Bank of Spain Financial Stability Review 35 (2018).

05

FIVE PILLARS FUNDAMENTAL FOR INVESTORS TO PARTICIPATE IN MARKET DEVELOPMENT

Five factors are fundamental to market development. Although many elements influence and factor into the decisions of investors, the following requirements have been observed in active markets as the most critical in determining whether a market is of interest to market players investing capital in already defaulted assets. Each of these elements has multiple subcomponents (figure 4). The factors are as follows:

- Significant volume. Volume justifies the cost of due diligence of a market as well as ongoing management of investments. Before bidding for a portfolio, investors incur significant due diligence expenses in pursuing legal, tax, and accounting research without any certainty that an investment will take place. For cautious investors, these costs can amount to US$1 million–$2 million, or more. For these expenses to be justified, there must be sufficient volume available for future purchases to offset the initial costs. Thus the cost of due diligence can be an inhibiting factor in smaller markets.

- Transferability. The possibility of efficiently buying or selling distressed assets between different entities, such as financial institutions, investors, nonbank entities, or specialized debt collection firms, is a critical condition for the market to begin and develop. In case of loans, the transfer process involves the sale of rights under the loan from the original creditor (lender) to a third party (investor). The transfer process in markets in earlier stages of development can often be legally unclear or subject to cumbersome legal and regulatory conditions, some of which can hinder the development of a market.

- Price gap. This is the difference between what investors are willing to offer and what sellers are willing to accept. Loans that are overclassified, overvalued, and under provisioned create a large price gap between sellers and buyers. A price gap will prevent sales even when volume is sufficient and transferability is not an issue. It can be the most important nonlegal challenge for a market to develop.

- Structure and servicing capacity
    - A suitable investment structure. For investors to efficiently fund the purchase price and to receive the upside on loan recoveries after recovery of the initial purchase price and costs, a suitable investment structure is critical. To purchase a distressed portfolio, investors typically prefer a bankruptcy-remote vehicle to which distressed assets can be transferred and which is ring-fenced.[3] The inability of a non-bank, non-licensed investor to purchase distressed assets using this type of vehicle can make investments more difficult and costly. The requirement to create and fund a domestic company could also make investment more costly for foreign investors. Similarly, the need for foreign investors to repatriate the upside on loan collections can also be a barrier if foreign exchange or foreign investment regimes do not recognize recoveries beyond the initial purchase price as eligible for repatriation.
    - Local servicing capacity. Investors rely on local servicing capacity because (a) servicers can be a valuable source of information in terms of local debt collection legislation and practices, as well as collection performance; (b) this information, in turn, is invaluable in supporting the underwriting and pricing of portfolios; and (c) local servicers are essential to the design and implementation of distressed asset recovery strategies.

- An efficient insolvency and enforcement framework. A strong legal foundation for insolvency and debt enforcement is necessary because investors rely on the judicial and extrajudicial framework to restructure and rehabilitate borrowers, as well as to enforce assets. Long recovery procedures affect the net present value of loan recoveries, with recovery cash flows discounted over a longer period. More predictable and shorter insolvency and debt enforcement procedures result in earlier cashflows and can therefore contribute to an increase in the purchase price.

3 Ring-fencing ensures the purchase entity is a legally insulated and structurally independent entity whose assets and cash flows are protected from the insolvency of the originator or other creditors of the borrower, thus making the purchase entity bankruptcy-remote.

Figure 4. Subcomponents within the Five Key Elements to a Well-Functioning Market

Volume/distressed asset data		Transferability			Price gap	Structure and servicing capacity			Insolvency, bankruptcy, and enforcement		
1 Market total loans	**7** Recent DA sales	**11** Conditions for transfer	**17** Step-in rights/ procedures	**22** Data access for due diligence	**23** Provisions/ LTV/risk	**Servicing capacity**	**33** National servicers list	**38** Int'l investor restrictions	**Debt enforcement and collateral**	**47** Discretion to stop/block sale	**52** Formal restructuring
2 DA vs. performing loans	**Information and due diligence**	**12** Offshore SPV	**18** Third-party guarantee		**Bank-related tax framework**	**28** Debt servicers license	**34** Servicer record	**39** Capital controls	**42** Collateral enforcement	**48** Professional appraisal	**53** Regime effective-
3 Loans by sector	**8** Spreadsheet data	**13** Borrower consent	**19** Collateral transfer		**24** Provisions deductibility	**29** Licensing criteria	**Asset ownership**	**Securitization**	**43** Bailiff performance	**Insolvency law**	**54** Consumer bankruptcy
4 Historical write-off	**9** Data sharing standards	**14** Special case loans	**Personal Data protection**		**25** Sale loss deductibility	**30** Local servicing capacity	**35** Distressed asset ownership	**40** SPV and full step-in rights	**44** Bailiff regulations	**49** Available data and information	
5 Historical restructurings	**10** Supervisory disclosures	**15** Transfer costs	**20** Data transfer with loan		**26** Write-off loss	**31** Consumer protection	**36** Activity/ service restrictions	**41** Asset manager	**45** Enforcement outside court	**50** Local insolvency regime features	
6 Successful restructurings		**16** Transfer under enforcement	**21** Data transfer w/o loan		**27** Collateral sale	**32** Collectors right/ powers	**37** Granting new money		**46** Foreclosure remedy	**51** Informal restructuring	

Source: IFC DARP.
Note: DA = distressed assets; Int'l = international; LTV = loan to value; SPV = special purchase vehicle; vs. = versus; w/o = without.

A. Volume

Volume is an essential factor for investors with a need to amortize market due diligence costs. Investors offset significant market due diligence costs with investments in multiple portfolios, an opportunity which smaller-volume markets may not provide. For this reason, investors carefully consider the volume of distressed assets—including written-off loans—potentially available for sale before proceeding with a detailed and possibly costly market due diligence.

Accurate data facilitate investor evaluation of market potential. It is important that financial institutions and creditors are able to provide quality data on the distressed asset portfolio, including, but not limited to, basic borrower information. To assess a portfolio, investors look for accurate data regarding the number and dates of contact with the client, payment history, accurate and complete loan files, and updated collateral valuations. This information is most optimal in digital format.

Low distressed asset volumes do not automatically prevent the development of a market. Even where volumes are low, local collection companies, which face lower costs and barriers of entry, can and do invest in smaller portfolios, particularly in those markets with consistent sales of distressed consumer loans. However, local collection companies are often limited by their own liquidity, and local lenders, as a rule, are reluctant to fund investments in distressed asset portfolios. In markets where potential creditors are unfamiliar with distressed asset pricing and investment, lenders may be reluctant to extend a loan to purchase assets that are in distress.

High NPL ratios are not always an indicator of a pressing need for financial institutions to sell. In

Box 2. Angola

High NPL Ratio but Banks Not Motivated to Sell to Private Investors

- Angola has observed elevated nonperforming loan (NPL) ratios for more than a decade, with NPLs exceeding 10 percent of total loans since 2014 and reaching as high as 32 percent in 2019.
- Although sectorwide NPLs were still elevated at 19 percent as of 2024, the composition of bank balance sheets is such that the pressure for banks to sell is limited.
    - Banks are highly liquid, with liquid assets to total assets exceeding 30 percent.
    - Bank investment portfolios, on average, are two to three times loans to customers and consist largely of government securities, risk free for capital purposes under Basel III.
    - The average loan portfolio is only 21 percent of total assets, such that NPLs are only 5 percent of total assets.
- As a result, bank regulatory capital is available to absorb the impact of NPL provisioning and risk weighting, reducing the need (and appetite) for banks to sell at a loss with a definitive impact on capital.
- Combined with other impeding factors, including a deficient framework for creating and enforcing collateral, banks have not completed any NPL sales beyond those reported by troubled public sector banks to the government-owned and -funded asset management company (Recredit) in 2020.

Source: Banco Nacional de Angola, Financial Stability Reports 2019 and 2020; International Monetary Fund, Article IV reports 2024.

markets with low banking penetration and where banks are highly liquid, a high NPL ratio does not always translate into a substantial volume of NPLs or distressed assets available for sale, especially when total credit is limited. In these cases, it is also critical to consider the ratio of NPLs to total assets. The NPLs/total loans ratio can mask the comfortable risk position of financial institutions when total lending as a percentage of total assets is low. For example, a high NPL ratio of 18.0 percent of total loans is only 4.5 percent of total assets when loans are only 25.0 percent of total assets. In situations in which total lending as a percentage of total assets is low, financial institutions can often easily support the risk weight of NPLs on capital and are reluctant to sell at discounts that distressed assets usually command. This has been observed in several EMDEs (box 2).

High NPL volumes may not always attract international investors if actual investment amounts are low. In some markets in which anticipated recoveries are low, pricing and the total investment amount per portfolio may be too low to attract international investors with minimum investment thresholds, higher transaction costs, and the need to deploy capital. For example, this is currently the case in Mexico, where, despite high NPL volumes, low prices and small investment amounts are a deterrent to cross-border investors.

When assessing volume, the most relevant features of a market include the following:

- Balance sheet composition is critical. Highly liquid banks and those with strong capital levels, combined with low lending as a share of total assets, are unlikely to sell at discounts that new markets require, regardless of the NPL rate.
- Breakdown of distressed assets by asset class. The purchase of collateralized distressed assets, in general, requires a larger-value investment and greater access to funding. Therefore, detailed information on the breakdown of distressed loans by consumer, SME, mortgage, and corporate classification is important to identify investors most suited to the asset class.
- Volume of write-offs. Financial institutions often want to sell off-balance sheet assets as well, increasing the volume available for sale. Frequently, these assets can be quite “old” in terms of days past due and may not command a significant price.
- Recent distressed asset sales and volume, if any. Recent sales are important not only in terms of identifying transaction precedent but also for understanding financial institutions’ interest in selling, as well as the experience of the local investors in buying and managing these assets.

B. Transferability

It is critical for the development of a market that loan transfers proceed as smoothly as possible. Transferring distressed loans involves a series of steps to ensure a legally compliant process, which leads to the investor becoming the new creditor, stepping into the legal and procedural position of the original creditor post sale. The transfer usually begins with the execution of a transfer agreement, which specifies the terms and conditions under which the investor assumes ownership of the loan and the rights to collect. In many active markets, no regulatory approvals or notifications (beyond the borrower) are required for investors or financial institutions to conclude a sale. In many EMDEs, however, transferability to a nonbank, non-licensed entity may not be possible under existing legislation, and approval by an authority, where required, could be an impediment to market development.

Transferability can be hindered, conditioned, or both, by several factors, mostly of a legal nature. Some of the most prominent issues to bear in mind when assessing transferability include the following:

- Conditions for transfer. In many countries, the transfer regime is considered a debt assignment under private law, either civil or commercial. The regime normally considers the transfer of debt (distressed or not) valid and binding as of the date of the assignment agreement. However, for the transfer to be considered effective against the borrower, the assignment regime normally imposes an obligation to notify the borrower that the transfer has taken place. The notification process varies significantly among countries, with some jurisdictions requiring that the notification be delivered by a court officer with acknowledgment of receipt while others simply require that a registered letter be delivered at the borrower's address. In cases involving the transfer of loan portfolios or "bulk transfers" of bank loans, some countries (like Italy) have provided the option to rely on a simplified notification process that eliminates individual notifications and only requires registration with the Companies Register and publication in the Official Gazette. Where no special regimes exist, the general regime applies (see table 1).

- Offshore special purpose vehicles (SPVs). Regulators may have reservations on the use of foreign SPVs to hold distressed assets even though their legal position and collection rights are usually identical to those of domestic creditors. For this reason, in some EMDEs it may not be possible to use a foreign vehicle to purchase distressed loans from financial institutions. There may also be additional requirements and obligations in terms of notifications to, or regulatory approvals from, financial or consumer protection authorities. Offshore SPVs may be more frequently used by foreign investors, though domestic investors may rely on them as well.

- Borrower's consent. Borrower's consent is typically not required under the transfer regime, and notification is sufficient for the transfer to be considered completed (table 1). However, until the notification process has been completed, the borrower can validly continue making payments to the original creditor (the seller). Where the borrower's consent is required for transfer, it becomes a significant impediment to market development, since consent is unlikely to be forthcoming from borrowers in default. To mitigate this potential impediment, loan agreements in some jurisdictions may include clauses in which the borrower consents to transfer at the time of loan origination.

- Special situations. Some countries foresee exceptional cases in which the borrower's consent is required. Such cases may include the transfer of loans that are being litigated in court. Banking laws in some countries also impose requirements additional to those foreseen under contract law which may apply when the investor is a foreign entity or the loan is a particular type. These additional requirements complicate transferability and may result in the exclusion of these loans from the secondary market.

- "Step-in" rights. The investor should be able to have the same rights and position as the seller post sale. These step-in rights are sometimes acknowledged expressly under contract law, providing legal certainty and reinforcing transferability.

- Transfer under enforcement. When the distressed loans are in the process of being collected under a judicial procedure, it is essential that the investor can be subrogated in the legal position of the seller immediately after the transfer (table 1). This requires a specific provision allowing such subrogation, which the borrower should not be able to challenge. The absence of an express legal provision enabling the subrogation may lead to the buyer being required to restart judicial collection efforts, increasing the cost and time to recover.

- Third-party guarantees. When a loan has received a personal or corporate guarantee from a third party, most systems typically do not require that the guarantor confirm the guarantee upon transfer of the loan to a new creditor or investor. In these cases, no additional formalities are required post transfer, other than notification to the guarantor. The risk for the guarantor is not affected by the guarantee having a new beneficiary. However, in some special cases transfer of the guarantee requires confirmation and acceptance by the guarantor. As with debtor's consent, guarantor consent to guarantee transfer is unlikely to be forthcoming for a loan in default. When such consent is required, it could lead to little or no value being assigned to the guarantee by the buyer.

- Collateral transfer. In the case of secured loans, the regime applicable to the transfer of the collateral in favor of the investor is usually foreseen under the mortgage or secured transactions laws, which can impose additional

Table 1. Benchmarking Transferability Regimes under the Civil Code in Selected Countries

Country	Conditions for transfer	Debtor consent to transfer	Debtor notification requirements
France	The assignment must be completed in writing. Notification to the debtor is required to bind the debtor, but it is not a condition of validity; the assignment remains valid even if notification cannot be completed. Effectiveness against third parties is achieved immediately upon completion of the transfer.a	Debt assignments do not require debtor's consent, except if the debt was expressly stipulated to be non-assignable. In case of "litigious claims," the debtor has the right to redeem the claim by paying the purchaser the transfer price.	The Civil Code does not impose special requirements, although, traditionally, notifications were made via acte d'huissier (bailiff's writ). Since 2016, a simple notification suffices, typically completed via a registered letter with acknowledgment of receipt.
Indonesia	The assignment must be completed in writing. Notification to the debtor is required to bind the debtor, but it is not a condition of validity; the assignment remains valid even if notification cannot be completed.	Debt assignments can be completed without the borrower's consent.	The borrower must be notified of the assignment through a court bailiff (betokening), or the borrower must provide acknowledgment in writing.
Italy	No special form required. Notification to the borrower is required to bind the debtor but it is not a condition of validity. Effectiveness against third parties is achieved upon notification to, or acknowledgement by, the debtor.	Debtor consent is required only when the receivable is considered of a personal nature—that is, when the receivable is strictly linked to the person of the creditor or based on personal relationship.	To gain full enforceability, the notice should be delivered to or accepted by the debtor, or both, also in writing and bearing data certa, which requires registered mail or notarial certification.
Poland	Assignment must respect the form specified in the underlying receivable documentation. Notification to the borrower is required to bind the debtor, but it is not a condition of validity. Effectiveness against third parties is achieved upon notification to, or acknowledgement by, the debtor.	Debtor consent is required only when the receivable is considered of a personal nature.	Notification to the borrower is necessary but does not need to be confirmed, acknowledged, or countersigned by the borrower. Accepted forms include a registered letter with acknowledgment of receipt.
Romania	Assignment must respect the form specified in the underlying receivable documentation. Notification to the borrower is required to bind the debtor but it is not a condition of validity. Effectiveness against third parties is achieved upon notification to, or acknowledgement by, the debtor.	Debtor's consent is required only when the receivable is considered of a personal nature or caracter strict personal (similar definition to that in Italy).	No special requirements. Notification must provide proof of receipt by the debtor, typically through registered letters with acknowledgment of receipt.

Source: World Bank Group.

Note: Information in the table is as of the date of drafting of this note. Legislation and regulations do change over time. Table 1 covers only the regime applicable to loan transfers under the general regime (typically the Civil Code). Special transfer regimes applicable to certain subsets of loans, including transfers in bulk of bank loans, may also be applicable in these countries; these are not featured in this table.

a. The term effectiveness refers to the moment when the assignment becomes opposable (binding and enforceable) against third parties besides those included in the assignment agreement (the assignor and assignee), including other creditors of the borrower or bankruptcy trustees.

requirements. At a minimum, the investor must register the collateral under its name in the applicable registry once the sale has been completed. This is typically a straightforward process, but significant fees and taxes may apply. In some cases, the mortgage law can impose additional requirements, including securing the consent of the borrower (mortgagor), which significantly complicates transferability for the reasons previously explained.

- Data protection. Consumer loans include personal data from the borrower, which are typically considered sensitive and subject to additional protection under data privacy legislation. Data protection regulations may require that the data subject's consent be provided before any data are transferred, and this requirement may apply not only to the transfer of data under the transfer agreement, but also to the sharing of data during the due diligence phase, when the distressed asset investor is in the process of assessing the distressed asset portfolio.[4] The inability of investors to access data makes it difficult to assess portfolio quality. Some loan agreements include clauses permitting the sharing of personal data as per local legislation.

C. Price Gap

Provisions drive the sales of distressed assets across all asset classes. The first loans to be fully provisioned are usually unsecured consumer credits. If local regulations allow for sales to non-bank, non-licensed entities, consumer portfolios are often sold to specialized collection companies, which may already have been servicing similar portfolios for the selling creditor on an outsource basis. If a spike in distressed assets occurs in all asset classes simultaneously and provisions are adequate, sales in more complex asset classes such as corporate and SME credits will take place in parallel. In times of economic downturn, financial institutions will face a rapidly deteriorating loan portfolio and may have difficulty in sufficiently provisioning larger-value loans because of the impact asset revaluation would have on capital. Borrowers may be given deferred payment periods, reduced interest payments, and other forbearance measures to facilitate classification as "performing" and to avoid punitive classification of loans. To protect capital, financial institutions may provision only as much as the balance sheet can bear, delaying full provisioning for subsequent fiscal years to gradually absorb losses. These practices may sometimes be allowed by the regulator in times of economic distress and/or adopted following the introduction of new classification regimes.[5]

The underprovisioning of loans is a persistent issue with serious implications for market development and sales. Many factors explain underprovisioning in EMDEs, but the most common ones include overclassification to avoid costly provisioning, weak supervisory and regulatory oversight, overvaluation of collateral reducing provisioning requirements, and challenges in implementing IFRS 9 with its principle-based definitions. Adequate provisioning requires a coordinated approach among regulators, banks, auditors, and international institutions around key measures like enforcing realistic NPL definitions and classification and introducing mandatory regulatory floors for provisioning.

To accurately assess the price gap, adequate data must be available. Data allow investors to price portfolios more accurately, which in turn narrows the price gap. When data are not available, investors adjust pricing conservatively to compensate for

4 For this reason, during due diligence of the loan portfolio, the consumer's personal data are not provided to prospective buyers, and each borrower is simply identified by a borrower number.

5 For example, during the COVID-19 (Coronavirus) crisis, regulators permitted financial institutions to delay classification for certain limited periods. See "COVID-19 and Non-Performing Loan Resolution in the Europe and Central Asia Region" (World Bank Policy Note, World Bank, Washington, DC, December 2020), available here.

potential unknowns. Hence, the more granular the data provided by financial institutions, reported to the supervisor, and shared with potential investors, the more likely that investors will be able to offer a higher price for a distressed asset portfolio. In addition to basic data on the loan and borrower, such as original principal amount, date of default, and outstanding principal balance, it is essential that creditors be able to provide data on client contact and, above all, repayment history going back as far as possible as per the profile of the loan. Aware of the information asymmetries existing between investors and sellers, the European Banking Authority issued distressed asset templates to encourage the expansion of a distressed asset market in the European Union (EU).[6]

A major factor complicating or delaying adequate provisioning is collateral valuation. Often, real estate collateral value is not updated and remains on the financial institution's balance sheet at the same value assigned at loan origination; this results in overvaluation of collateral in an economic downturn. In situations in which real estate markets are depressed, it may not be possible to have a recent market reference price because of a lack of transactions and, therefore, it also may not be possible to update valuations. As a result, overvaluation of real estate collateral for a secured loan can be a major factor in the price gap between lender and investor.

When the potential for a price gap is assessed, applicable taxation plays an important role. For financial institutions, distressed asset sales may require the recognition of losses, which may not always be deductible for tax purposes. For the investor, distressed loan purchases may be deemed an ordinary acquisition of property subject to transfer taxes or registration taxes, which further increases costs for the investor and therefore lowers the purchase price for the seller. In all these cases, an adverse tax treatment can create disincentives that prevent the development of a distressed asset market. The approach taken to the following selected key issues varies greatly from country to country (table 2).

- Tax deductibility of provisions. In some countries, the specific provisions adopted by financial institutions in implementing the regulator's accounting and prudential framework may not be considered deductible for tax purposes. Limits on the deductibility of provisions by financial institutions may result in under-provisioning of loans, potentially leading to higher losses to be realized at the time of the sale if the net book value (NBV) of the distressed assets on the financial institution's balance sheet is higher than market value or the price offered by the investor. The non-harmonization of the regulator's provisioning requirements with the tax authorities' deductibility rules has proved to be a substantial impediment to the development of a distressed asset market in several countries. Financial regulators are usually keen on having tax rules for loan loss provisions align closely with prudential regulations to encourage financial institutions to recognize erosion in asset quality in a timely manner. But tax authorities often fear that accepting prudential rules for tax purposes will significantly reduce income taxes paid by financial institutions.
- Sale loss deductibility. Distressed asset sales may take place at a discount to loan net book value. It is not unusual that the offer price—when asset deterioration has been sudden and swift following a financial or economic shock—falls short of the distressed asset's net book value. In these cases, there is an additional loss that the financial institution must take at the time of the sale. While the deductibility of provisions may be allowed, some tax laws impose limitations on the deductibility of this additional loss, with the explanation that the seller cannot deduct

6 "Implementing Technical Standards on NPL Transaction Data Templates" (European Banking Authority, Paris, 2023).

Table 2. Benchmarking Tax Deductibility of Provisions and Losses Arising from Sales Below NBV

Country	Ability to deduct provisions as per regulatory guidelines from taxable income in the year taken	Ability to deduct losses arising from the sale of loans below NBV from taxable income
France	Yes, provisions are deductible under a general tax provision applicable to all taxpayers facing risk of nonpayment.	Yes, losses are deductible under a general tax provision defining expenses for all taxpayers. Sales below NBV by any creditor would fall under the definition of ordinary expenses.
Morocco	Yes, provisions created by financial institutions following the prudential framework are deductible but subject to the condition that the financial institution start judicial recovery actions within 365 days from the creation of the provision.	No, losses incurred at the time of the sale are capped at the provisions taken. If additional losses beyond the provisions created arise, they are not deductible.
Romania	Yes, provisions created by financial institutions following the prudential framework are deductible.	Yes, but subject to a cap of 30%. For receivables assigned by financial institutions, if the sale is below NBV of the distressed asset sold, the loss is deductible within a cap of 30% of the deductible loss when calculating corporate income tax.
Senegal	Yes, provisions created by financial institutions following the prudential framework set by the regulator are deductible.	Yes, losses are deductible, but with a three-year limit on the ability to deduct losses in future years if the deduction cannot be applied in the year when the loss arose.
Spain	Yes, provisions created by financial institutions following the prudential framework are deductible under a special rule applicable to financial institutions, with the exceptions of loans granted to related parties and state-guaranteed loans.	Yes, losses are deductible under a general tax provision defining expenses for all taxpayers. Sales below NBV by any creditor would fall under the definition of ordinary expenses.
Türkiye	Yes, provisions are fully deductible under a special regime available for banks under the Banking Law.	Yes, losses are deductible under a general tax provision defining expenses for all taxpayers. Sales below book value by any creditor are considered ordinary expenses.
United States	Yes, provisions are deductible for entities under the conformity regime regulated in the Internal Revenue Code (tax code).	Yes, losses from loan sales are considered an ordinary loss for the selling creditor, which will be offset against ordinary income.

Source: World Bank Group.
Note: NBV = net book value.

losses beyond those mandated by accounting and prudential regulations or in excess of stated collateral value. In these circumstances, it will be difficult for the financial institution to sell at the price offered by the buyer, resulting in a tax-driven price gap.

- Write-off loss. Tax laws can also take different approaches to write-offs, delaying the moment when a financial institution may be able to take a "definitive loss" and remove an exposure from its balance sheet. Some countries require that the financial institution demonstrate that it engaged in exhaustive legal collection proceedings before an NPL can be written off. In some cases, tax authorities may assimilate distressed asset sales to write-offs for tax purposes, since they both imply the removal of the exposure from the balance sheet and the acceptance of a definitive loss. In such circumstances, financial institutions may prefer to retain partially provisioned (and expensed) NPLs on their books if a potential NPL sale will result in a reversal of expenses and an increase in taxes.

D. Structure and Servicing

A complete discussion of investment structure and funding options for distressed asset acquisition and the impact various options have on cost and operational efficiency of distressed asset investment would be quite extensive and complex and merits its own paper. The following information provides a simple overview to convey the basic elements of distressed asset investment as well as the potential complexity that could arise when structuring such an investment.

An important factor for investors is the type of investment vehicle that can buy and own distressed assets. Multiple options are available, including onshore or offshore and regulated or nonregulated vehicles. The type and jurisdiction of incorporation of the vehicle affect funding costs, and, if cross-border funding is required, then hedging costs, capital controls (where applicable), foreign exchange costs or controls (where applicable) are among elements affecting cost. Associated tax rules have an impact as well. All these elements need to be taken into consideration when an investment is priced and may prevent the development of a distressed asset market when too complicated and costly. Investors may not consider distressed asset portfolio purchases in markets where the costs and regulations associated with available investment structures result in insufficient expected returns, regardless of whether the market has a sufficient volume of adequately provisioned NPLs and satisfactory servicing capacity.

In active markets, there are minimal or no requirements for the authorization of investors or their investment vehicles. The EU considers that investors in distressed assets are not creating new credit but buying existing credit at their own risk; therefore, they are not of prudential concern and their potential contribution to systemic risk is negligible. Consequently, it is not necessary for investors to apply for authorization before purchasing distressed credits from financial institutions in EU countries (see table 3). All EU and national consumer protection rules as well as other legislation continue to apply, and borrowers' rights remain as per the initial credit agreement.[7]

An offshore SPV incorporated in a tax-efficient jurisdiction is often the preferred investment vehicle for international investors acquiring distressed asset portfolios, since these jurisdictions allow for a variety of funding options, have legal regimes adapted for financial investors, and possess the required legal and accounting professional infrastructure to support and monitor the use of SPVs. These jurisdictions are often tax neutral in terms of aggregating capital from investors with different jurisdictions of origin. Some EU countries, such as Ireland, Luxembourg, and the Netherlands, have developed legislation that supports the use of such vehicles, with the objective of facilitating the packaging and sale of all types of financial sector assets.

In contrast, some EMDEs have imposed various requirements for the acquisition and ownership of distressed assets. A common requirement is the mandatory use of a domestic vehicle. Several EMDEs, such as, India, South Africa, and Viet Nam, among others, permit only domestic entities to buy and hold distressed assets of financial institutions (see table 3). In other markets, local legislation has restricted distressed asset sales to licensed local entities. In these markets, a potential investor needs to incur the costs of creating and licensing an investment vehicle before knowing whether any portfolio purchase will be completed successfully. This is the case in Türkiye as well as in India. These formalities increase costs of entry to the market for all players and can slow market development. Ultimately, it is volume that offsets the cost of investment—including the cost of a licensed vehicle.

7 EU Directive 2021/2167 on credit servicers and credit purchasers of 24 November 2021, para. (40).

Availability of adequate, skilled credit servicing capacity is critical, especially for investors without a significant domestic presence. All investors will rely on local servicers to recover on the distressed assets transferred from the original creditor. Consumer credits are often dealt with through a call center or through more automatic processes such as telephone or messaging applications. For complex corporate loans, legal, financial, and operational skills may be essential, and loan recovery is usually more costly, with a longer lead time to develop.

Local servicer information can mitigate pricing uncertainty. Every market is different, and investors look to confirm their pricing assumptions with local servicers who may already be familiar with the recovery performance of the various asset classes. Recovery performance varies across markets, but also within markets where similar portfolio profiles may have vastly different recovery performances, which can be a function of the underwriting practices of the original creditor. Credit servicer knowledge is an important element in being able to more accurately predict recovery, potentially reducing the price gap.

Table 3. Benchmarking Purchaser Requirements in Selected Countries

Country	Purchaser requirements and/or restrictions
France	If loans/NPLs are already due and payable or accelerated, no restrictions apply. Only certain authorized financial institutions may buy nonaccelerated loans.
India	Only licensed ARCs with minimum capital requirements can buy NPLs and distressed assets from financial institutions.
Kazakhstan	Financial institutions are required to hold consumer loans for two years following default before sale.
Romania	No restrictions on the transfer of corporate distressed assets. Nonaccelerated loans can be bought only by financial institutions.
Spain	No restrictions regarding the eligible purchasers of banking loans. Specific consumer protection rights are in place regarding residential mortgages.
Serbia	Only banks can buy consumer NPLs.
Türkiye	Only asset management companies licensed by the regulator and with minimum capital requirements may buy and service NPLs.

Source: World Bank Group.
Note: ARCs = asset reconstruction companies; NPLs = nonperforming loans.

Two alternatives to dispose of distressed assets exist: direct sales and, in some cases, securitizations. The greatest volume of distressed asset transfers globally is completed through direct sales. In some countries, because of regulatory or legislative constraints on transfer or ownership, securitization may be the only way to transfer loan assets. However, securitizations have capital market requirements that often make it a more expensive and time-consuming option with features that are not always pertinent for the type of investor willing to invest in distressed assets. Distressed asset buyers are sophisticated buyers who conduct their own due diligence and are "buy-and-hold" investors, with no intention of trading the instruments used to fund the purchase nor any intent to sell the investment to the public. For nascent markets, direct sales are the most efficient option for developing the market at scale, although securitization can be used, if available, and where direct sale is not possible. In some markets, capital market regulators may make concessions on applicable requirements for distressed asset securitizations where the notes issued by the vehicle are not listed nor traded, as well as privately placed with sophisticated investors.

Main Features of Direct Sales

- In a direct sale, the distressed loan portfolio is transferred by the seller to the buyer under the terms of a transfer agreement. Direct sales using commercial agreements are faster in terms of execution time frame and usually are more modest in terms of legal costs. The seller can achieve full derecognition of the exposures transferred with an associated risk-weighted asset reduction. Since there is no possibility of deferring the recognition of losses, a sales price below the creditor's NBV of the distressed assets would have an immediate impact on the creditor's income statement.

- In direct sales, investors who buy the notes or obligations issued by the SPV participate in the portfolio due diligence and pricing and are well aware of the risks to be incurred. With a direct sale using an SPV with funding from due diligence participant investors, there is no need for an information memorandum, a rating (which would likely be low, given the uncertainty of repayment of the underlying distressed assets), or a securitization asset manager—all of which are normally required by capital market authorities for securitization instruments.

E. Insolvency and Enforcement

The importance of insolvency and creditors rights (ICR) systems.[8] Loan enforcement and insolvency frameworks provide legal and specific procedures for creditors to follow to realize their claims and recover collateral. As such, they are the main tool that distressed asset purchasers will rely on to collect the loans they purchase. Contractual settlements or "workouts" under which the debtor agrees to fully or partially repay the original obligation are also considered part of the ICR system. ICR systems are not only key to developing a market, but also essential for the broader debtor and creditor community in the country, and therefore fundamental to promote the efficient flow of credit.

Insolvency and enforcement systems have four direct impacts on distressed asset portfolio valuation. (a) The time required to enforce and resolve distressed assets. Long enforcement procedures and the lack of specialized judicial capacity lead to delays in loan and collateral enforcement. These delays defer cash recovery, affecting the net present value of the distressed asset portfolio recovery cash flows. (b) The costs involved in enforcing or resolving distressed assets, which are included in investors' pricing models. The longer and more complex ICR procedures are, generally the higher the costs for investors. (c) The predictability (or lack thereof) of the outcome of the process. If an investor is unable to predict the outcome of the recovery process, it is more difficult to value the distressed asset, most likely resulting in a lower price, widening the price gap. (d) The ICR framework, via judicial collection, serves as the fallback option or worst-case scenario that investors will rely on to set their baseline recovery estimates. As a result, the ICR system may set incentives for the debtor to repay and settle obligations, thereby creating a stronger payment culture.

8 The World Bank, in collaboration with the United Nations Commission on International Trade Law, is a designated global standard setter for insolvency and creditor/debtor rights, as recognized by the Financial Stability Board. The World Bank's "Principles for Effective Insolvency and Creditor/Debtor Regimes" (World Bank, Washington, DC, 2021) (ICR Principles) is a key benchmark for countries evaluating and strengthening their insolvency systems.

Various key features within the ICR system are critical for the development of a distressed asset market. The following are the most relevant:

- Duration of procedures. Both (a) individual loan enforcement before insolvency and (b) recovery from insolvent debtors in actual insolvency procedures for all creditors can abound with opportunities for debtors, in some cases, to delay foreclosure, collateral execution, or liquidation. In addition, a lack of knowledge of insolvency and bankruptcy procedures by magistrates or judges as well as a lack of understanding of the financial condition of the borrower can also delay processes. For processes to be efficient, all stakeholders—judges, lenders, and borrowers—must understand and make efficient use of the available legislation as well as financial information.
- Out-of-court enforcement. To minimize delays and maximize the efficiency of enforcement procedures, it is important that the ICR systems allow creditors to enforce their security without relying on, or with limited intervention of, the court system. Such an option can be made available for enforcement over commercial loans, for which consumer rights are not a concern and which may stipulate that the borrower and the creditor agree on the private sale of the collateral as a valid means of enforcing the loan.
- Bailiff regulations and performance. The ICR system often relies on the judiciary to complete collection procedures, and court bailiffs can play a significant role in establishing efficient procedures, including in cases where enforcement does not rely on the court system. Having a body of professionals that is specialized, supervised, well-trained, and appropriately compensated makes a significant difference.
- Consumer insolvency. ICR systems should feature the possibility for a consumer to access a “fresh start” and discharge a debt that cannot reasonably be repaid during a specified period (typically up to three years). Consumer insolvency systems must balance debtor protection against creditor rights, which should ensure that collateral, where available, be respected.
- Specialized courts. Insolvency procedures are more efficient where there are specialized courts with expedited procedures, such as in Indonesia, Thailand, or the United States. When the judiciary plays a key role in distressed asset resolution, especially in corporate restructurings, cases tend to take longer and court capacity can be the cause of significant delays, which are detrimental for creditors as well as investors.
- Avoidance actions. Upon the opening of insolvency procedures, transactions completed by the debtor over a specified period preceding the opening of the case are subject to enhanced scrutiny by the court and the insolvency administrator. This is commonly referred to as the “suspect period.” When a transaction has been deemed to be completed on preferential terms or at a value less than market, the court has the authority to “unwind” that transaction. The ICR system should introduce clear limits to certain transactions during the suspect period, so that the ability of the court to unwind these transactions occurs over a clearly established period and under clear grounds. These limits provide certainty that distressed asset transfers, which often are completed below net book value, are not unduly overturned.
- Creditors’ priorities. ICR systems establish the hierarchy of creditor claims, determining the priority of repayment of creditors included in the estate. It is critical that the priority afforded to secured creditors at loan origination be respected when it is most needed—that is, when the borrower enters insolvency (table 4).

Table 4. Benchmarking Priorities in Selected Countries

Country	Secured creditors' priorities over collateral in insolvency proceedings
Brazil	Labor claims (up to 150 times the minimum wage) rank above secured creditors in insolvency proceedings. Secured creditors lose priority over this portion.
Canada	Unpaid wages receive super-priority over secured creditors, up to $2,000 per employee.
France	Unpaid wages and salaries have absolute priority, even over secured creditors. The Wage Guarantee Fund pays employees and is then subrogated to their rights, with a first-ranking charge.
South Africa	Wages and other employment-related claims are considered preferent claims, ranking above those of unsecured creditors but not those of secured creditors.
United States	Secured creditors are paid from the proceeds of the specific collateral securing their claim. Priority unsecured claims, including labor and tax claims, are paid after secured creditors have received full payment.

Source: World Bank Group.

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Support throughout from relevant government authorities for regulatory reforms and for ensuring that the market adopts appropriate distressed asset resolution practices is key to achieve an efficient and transparent market in a shorter period.

06

CONCLUSION

This note has highlighted the importance of developing distressed asset markets, which can serve as a pressure release valve for the entire financial system. When functioning properly, such markets can contribute to financial stability, support economic recovery, and promote access to finance.

The importance of the role the government plays cannot be overemphasized. Authorities are central to any reform process, as they support and facilitate the creation of needed institutional, regulatory, and other market conditions that facilitate the participation of private sector investors. The government does not dominate the market but sets the rules, reducing uncertainty and—if necessary—bridging initial gaps in liquidity or risk tolerance so that markets can function effectively.

There is no one-size-fits-all approach to developing a distressed asset market, and policy makers in each country will have tailored approaches that reflect local conditions and objectives. The approach will naturally depend on priorities set by the authorities, the needs of local stakeholders, and the political environment surrounding the reforms required to activate or optimize the development of a market. As a result of the diversity of approaches, markets can develop differently, and each may have its own particular features, reflecting, again, unique local conditions.

Despite country differences, this report has identified some common denominators, or pillars, that are frequently observed in more mature distressed asset markets. These pillars can be a useful tool to analyze market development or potential for market development in EMDEs as well as to identify the reasons markets are not present or are not developing properly. Even when all elements are present, market development may falter. Even when a market does develop, the process takes time. Support throughout from relevant government authorities for regulatory reforms and for ensuring that the market adopts appropriate distressed asset resolution practices is key to achieve an efficient and transparent market in a shorter period.

ANNEX I

A Few Key Questions to Facilitate a Market Diagnostic

Country	Secured creditors' priorities over collateral in insolvency proceedings
Volume	• What are NPLs/total loans and NPLs/total assets? • Are total loans/total assets less than 50%? • Are banks highly liquid and is CAR above regulatory requirements? • Does investment in government securities exceed loans to private borrowers?
Volume	• What is the total US dollar or euro volume of NPLs? • What is the distribution in percentage across asset classes (consumer, SME, corporate)?
Transferability	• Is it possible to transfer financial institution credit to a nonfinancial institution, nonlicensed entity? • Is borrower approval required for loan transfer? • Does all security transfer together with the loan and is transfer automatic? • Is borrower or guarantor approval required for the transfer of any guarantees? • Will investors have access to collateral registries and credit bureau information?
Price Gap	• Can financial institutions deduct from taxable income provisions taken in line with regulatory requirements? Are there any restrictions on deductions? • Is the NPL coverage rate above 80%? • Can financial institutions deduct losses arising from sales of loans below net book value? • Has there been a recent, notable decline in real estate values? • Are collateral values regularly updated and are valuations done by external, qualified, or licensed valuators? Do valuators use international standards for valuation? • Are banks sufficiently well-capitalized or are NPLs causing capital adequacy concerns?
Structure and Investment	• Does local legislation permit the use of special purpose vehicles (other than securitization) such that assets can be segregated and returns to investors are only from the assets in the vehicle and not any other entity? • What are the options for the creation of a local company to invest in distressed assets? • Can local companies borrow domestically as well as from international lenders immediately following creation? Can local companies issue privately placed notes immediately following creation? • Are there any restrictions on foreign investment, restrictions on repatriation of foreign investment, or both? • Are capital controls currently in place? • Is access to foreign currency restricted?
Insolvency, Bankruptcy, and Enforcement	• What is the average duration of debt enforcement and insolvency procedures? • Are out-of-court enforcement or restructuring options available and efficient at resolving financial distress? • Do secured creditors receive absolute priority over the value of the collateral they hold as security? • Is the auction system efficient at adjudicating assets to third parties at fair market values? • Is the insolvency system successful at preserving value and enabling the reorganization of distressed but viable companies?

Note: CAR = capital adequacy ratio; NPL = nonperforming loan; SME = small and medium enterprise.

NOTES

Schweizerische Eidgenossenschaft
Confédération suisse
Confederazione Svizzera
Confederaziun svizra

Swiss Confederation

Federal Department of Economic Affairs,
Education and Research EAER
State Secretariat for Economic Affairs SECO

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