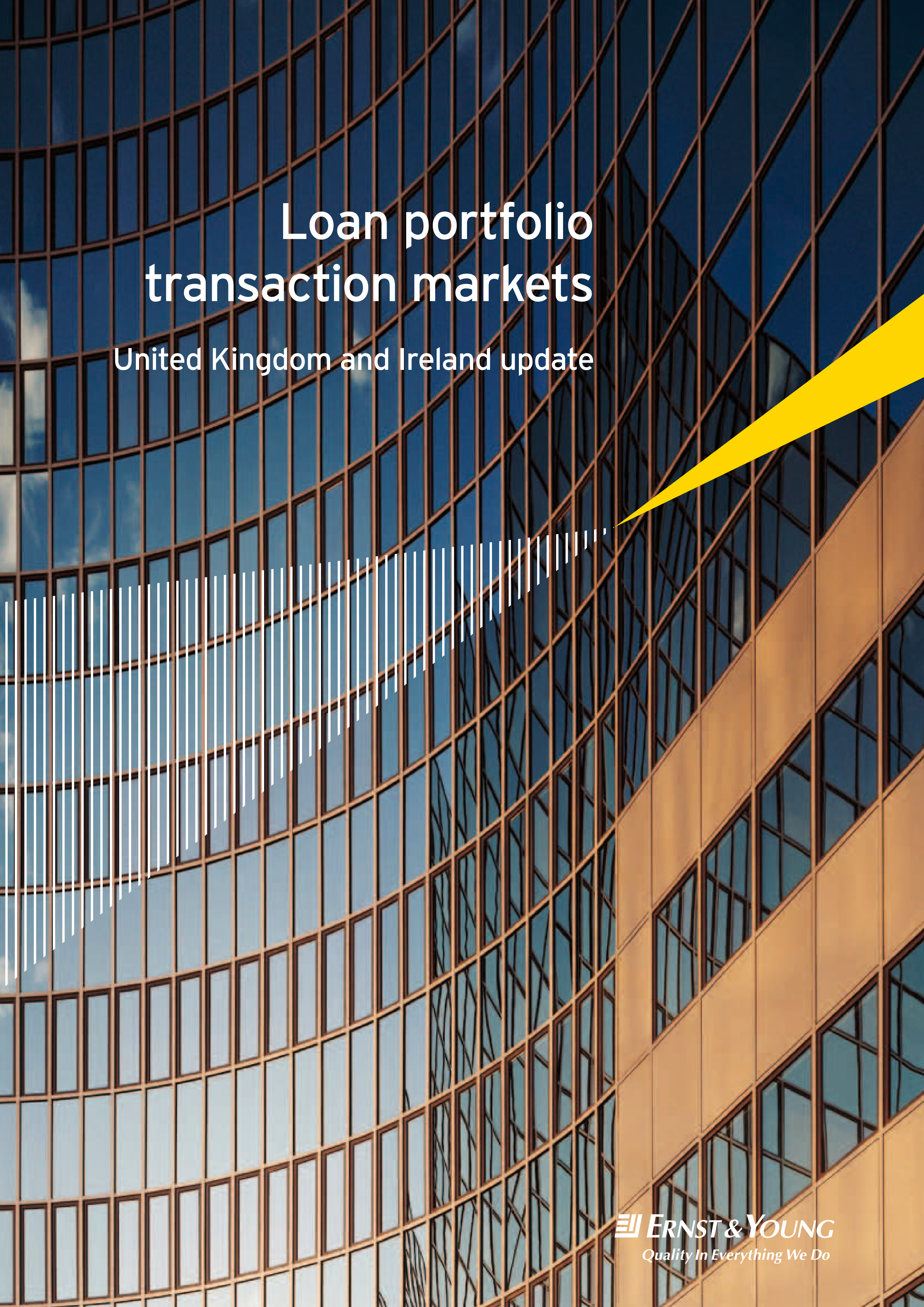


Loan portfolio transaction markets

United Kingdom and Ireland update

Ernst & Young
Quality In Everything We Do

Contents

Foreword

Ernst & Young's loan portfolio solutions team has been created to provide solutions, not services, to clients in loan transactions focused around real estate, retail and corporate loan transactions.

We work with a broad range of banking, private equity and institutional clients seeking advice and support in executing sales as well as advising on acquisitions ranging from some of the largest portfolios to single loans.

Welcome to the Ernst & Young loan portfolio solutions' 2012 review and outlook for loan transactions for the UK and Ireland.

As we turn the page on 2012, we review what has been a busy year for the loan transaction market and discuss the major themes that will drive the market in 2013 across our main sectors: real estate, retail and corporate.

Overall, we expect the flow of loan transactions to continue as banks press on with deleveraging and more buyers enter the market.

Single loan or portfolio real estate and corporate loan sales will continue to feature prominently with similar transaction volumes expected in 2013.

We also expect transactions involving secured and unsecured consumer debt to increase throughout 2013, driven by increasing buyer appetite and vendors' willingness to consider selling a broader category of assets.

We look forward to continuing to work with our clients and helping them meet the challenges to come in 2013.

Ernst & Young's loan portfolio solutions team

Commercial real estate NPLs – off to a good start, but where are we headed?

Over the last 18 months we have seen the beginnings of a non-performing commercial real estate loan market within the UK and Ireland. While it has not been the wave of transactions that some market commentators had predicted, at least nine portfolios with a total outstanding principal balance in excess of £8bn have come to the market with no shortage of investors willing to participate in highly competitive processes in the hope of securing one of the non-performing loan deals in the cycle.

Date	Transaction detail	Vendor	Acquirer	UPB (mn)[1]	Discount[2]
September 2012	Project Forth, UK RE loan portfolio	Lloyds	Deutsche Bank/Kennedy Wilson	£780	50%
September 2012	Project Pittlane, Irish RE loan portfolio	Lloyds	Apollo/Carval	€2,200	75%-90%
June 2012	Project Pivot, UK RE loan portfolio	Allied Irish Bank	Aborted	£380	-
May 2012	Project Harrogate, UK, Jersey and Irish RE loan portfolio	Lloyds	Oaktree	£620	58%
May 2012	Project Kildare, Irish RE loan portfolio	Allied Irish Bank	Lonestar	€650	60%
April 2012	Project Prince, Irish RE loan portfolio	Lloyds	Kennedy Wilson	€360	83%
September 2011	Project Royal, UK RE loan portfolio	Lloyds	Lonestar	£900	40%
September 2011	Project Byron, UK RE loan portfolio	Bank of Ireland	Kennedy Wilson	£1,450	20%
July 2011	Project Isobel, UK RE loan portfolio	RBS	Blackstone	£1,360	30%

Source: Press search, date shown represents date initially reported in the press
Note: Yellow boxes denote transactions on which Ernst & Young advised

1 Unpaid Principal Balance (UPB) as denominated in local currency
2 Discount as a percent of UPB as reported in the press

Commercial Real Estate NPLs (continued)

RBS was the first lender to approach the market with the £1.4bn Project Isobel. This transaction was complex both in terms of underlying loans and structure, with RBS retaining a significant interest in the portfolio. Lloyds Banking Group, Bank of Ireland and Allied Irish Bank have followed suit with transactions that were less complex both in terms of transaction structure and the nature of the underlying loans.

Most of the portfolios traded to date have been significant in terms of outstanding loan balances and the level of equity investment required. For potential acquirers, the size of the transaction and in most instances the requirement from vendors for bids to be fully funded have meant extensive and costly levels of due diligence, leading to a natural selection of bidders who have the resources and platform to invest significant sums up front.

Processes have tended to follow a two-stage approach, with a large number of parties involved in the first stage often cut down to three or four bidders for the second stage. While the level of competition has been high for all transactions, the quality of information, another key driver for pricing, has been mixed and has tended to negatively impact value where information was incomplete or of poor quality.

As the table on the prior page illustrates, we have also seen a significant difference in headline prices between UK and Irish loan books. To date UK portfolios have traded at 20%–50% discounts from UPB (depending on the relative distress of the loans), whereas loan books with significant exposure to Ireland have traded at significantly greater discounts. This difference is principally explained by the significant decrease in real estate values over the last number of years as well as the expectation that the workout period for Irish loans will be considerably longer than loans in the UK, where the market and the properties tend to be more "liquid."

Finally, we have seen an increasing number of lenders prepared to fund the acquisition of loan book portfolios. While the quality of the underlying properties would have typically meant that these same lenders would not have wanted to finance their acquisition, the quality of the sponsors, the shorter tenor and the attractive returns have led to increasing numbers of lenders getting comfortable with these "loan on loan" structures, where pricing typically ranges from 500–700 bps.

What should we expect in the next 12 months?

While a significant amount has already transacted over the last 12 months, it is clear that the commercial real estate non-performing loan market is in its infancy.

Banks across Europe still need to reduce their exposure to commercial real estate loans, and we expect banks to continue to use loan sales as a way to achieve this goal to reduce their capital commitment to the sector.

We also expect a rebalancing in the relationship between vendors and acquirers as the market becomes more mature, both sides become increasingly sophisticated in their approach to selecting loans for sale, and as acquirers establish their workout platform.

There is no clear pipeline that one can use to track future deal flow but taking into account the scale of the deleveraging issue and the fact that we expect most banks to also continue to work out their loans "in house" where loan sale requires too much of a discount, we expect the total volume of loans traded to remain broadly at the same level in the near term.

In our view this volume is likely to be achieved by an increase in smaller portfolio sales coming to market as banks look to widen the list of potential buyers to institutions and specialist investors with less financial firepower. This reduction in transaction size is also likely to be driven by smaller banks, building societies and subsidiaries of foreign banks coming to the market, recognising the smaller size of their overall real estate loan books.

In addition to portfolio sales we expect a continuous flow of single loan disposals as banks look to benchmark their long-term workout strategies with solutions that bring both capital and liquidity relief on a deal-by-deal basis.

In all situations pricing will continue to reflect the difficulty and time involved in working out these situations, as well as the quality of the information provided during the sale process.

Finally, with a number of buyers looking to realise value, often via asset sales over shorter timetables to boost their return, it will be interesting to see whether the increased level of real estate coming to the market will put further downward pressure on property values where there is already limited demand for the existing stock and how this will ultimately impact the pricing of future loan portfolios.

How to get it right?

The question on most buyers' and vendors' minds is how to get it right. For vendors, that can mean how to achieve the highest price, or for buyers, how to win auctions while maintaining credible business plans that will allow return hurdles to be met.

For vendors, simplicity, quality and clarity of the information package are key, followed by an approach to asset selection that takes into account target buyers' appetite.

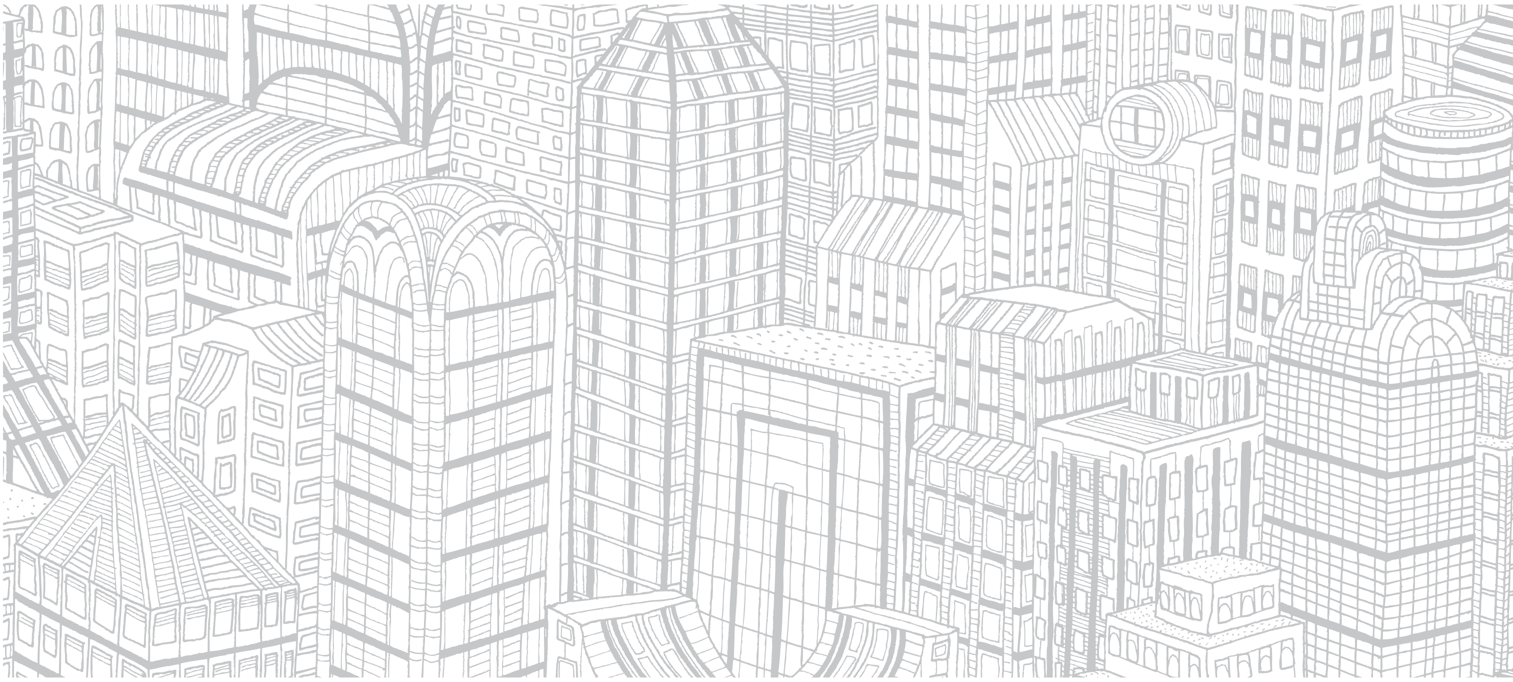
For buyers, this involves understanding the market for the underlying collateral and partnering with best-in-class operators and advisors that understand the critical paths to delivering value to support robust pricing analysis and ultimately the implementation of their realisation strategies.

Conclusion

While we can now talk about a real estate non-performing loan market in the UK and Ireland, it is still an emerging market.

We expect banks will continue to choose loan sales as only one of the solutions used to support their deleveraging strategy, although it is likely to be the most visible and widely publicised.

As the market becomes more mature both vendors and acquirers will look to build greater efficiency and streamline transaction processes. Thorough financial analysis encompassing the full spectrum of value drivers is required to achieve this efficiency and will continue to require significant effort from both sides early in the transaction life cycle.



Retail assets — unsecured

The UK market for unsecured loan transactions

The debt purchase industry in the UK (which exists to acquire non-performing unsecured loans from banks, telcos, utilities, government, etc.) has been developing and maturing over the last 10 years. Activity in the last three years, however, has seen this market take a number of interesting, and transformational turns.

2009 and 2010 — building the wall of debt

Traditionally debt purchasers have acquired non-performing unsecured loans on a highly leveraged basis (60%–100% advance rates with debt funding provided by banks depending on collateral available against back books). However, during 2009 and 2010, with liquidity constraints at the banks arising from the credit crisis, and with question marks as to how collection rates would hold up for debt purchasers in a recessionary environment, the traditional lenders to this market started to retrench (Barclays notably pulled out, having previously provided significant liquidity to the market). This resulted in a lack of demand (at prices vendors were willing to trade at).

At the same time, given the recessionary environment, levels of delinquencies increased and with it the potential supply to the debt purchase market. This gap between demand and supply grew, with many believing a "wall of debt" was being amassed (particularly within the banks) that would ultimately need to be unlocked through transactions.

2011 and 2012 — the return of liquidity and the advent of the "megadeal"

The first steps toward a clearing market were taken in 2011. During 2011 three major debt purchasers (Cabot, Lowell and CapQuest) successfully completed corporate transactions, and alongside these transactions new debt facilities were implemented. Two further corporate transactions followed — those involving Experto Credite and Sigma. This increase in liquidity started to unlock the pent-up supply, but in a different way than those that observed historically — we saw the advent of the "megadeal" or "whaledeal," whereby consideration on non-performing loan transactions totalled tens of millions of pounds (as opposed to £2–5mn as supported by the traditional model) against portfolios in excess of £1bn of face value.

Retail assets – unsecured (continued)

Pent-up supply, strategic market exits, secondary sales and the ability of the market to execute given its enhanced liquidity all contributed to the advent of the megadeal:

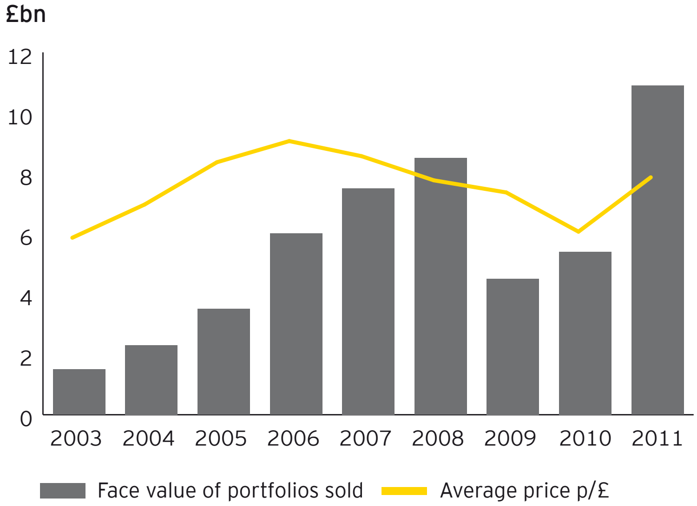
- Strategic market exits included Citi's disposal of the Egg portfolio (the performing portfolio, the deposit portfolio and the operations having already been sold to Barclays and Yorkshire Building Society) and MBNA's ongoing retrenchment from European markets.
- Secondary sales included CarVal's disposal to Arrow – refocusing on its core competency (fresher debt) and freeing up liquidity for more megadeals.

The activity of 2011 continued to require reactions in 2012. On the supply side, banks with significant backlogs have wanted to access newly formed liquidity – this resulted in a number of retail banks executing "mega-disposals."

On the demand side, traditional debt purchasers have benefited from the entry of new lenders to the traditional RCF market (e.g., DNB and GE). Further, additional pools of liquidity have begun to address the market, including liquidity from foreign trade players, credit funds and debt capital markets:

- PRA's acquisition of Mackenzie Hall and Hoist's acquisition of Robinson Way have resulted in an augmentation of domestic liquidity with foreign trade liquidity.
- Credit funds with a preference for shorter-term, higher-liquidating debt (that supports their return hurdles but that is capital intensive) have started to form strategic partnerships with debt purchasers to address megadeals on a "one stop shop" basis.
- Cabot and Lowell have successful issued seven-year public bonds, giving them longer-term funding and greater flexibility in terms of what and how they purchase.

Evolution of the UK unsecured debt purchase market



Source: EY estimates

The outlook

The market looks like it will continue to develop as more corporate transactions are contemplated and more public bonds are rumored, as international trade players consider further market entry, and as banks increasingly employ "mega-disposals."

However, challenges remain – prices are being bid up (spotting when they are too high will be key), question marks remain with respect to funding model (e.g., what impact will ringfencing have on the cost of funding from traditional lenders?) and potential changes with respect to regulatory compliance are currently unclear, with responsibility soon to transfer to the FCA.

The Irish market for unsecured loan transactions

- To date the Irish market has been driven by very different dynamics to that of the UK. Activity has been led by overseas lenders looking to exit certain areas of business and/or non-performing assets. A number of institutions have sold motor finance loans alongside other asset finance receivables to financial investors.
- Aside from MBNA's sale of its Irish operation to Apollo, we have not seen much activity around defaulted credit card or unsecured loans, the mainstay of the UK market.
- The pending personal insolvency framework introduces uncertainty into forecast collections performance.
- Notwithstanding, we believe that in the short term there will be sales of unsecured debt from exiting institutions and there is certainly plenty of interest from the investor side in seeing whether a sustainable market for the sale of non-performing unsecured debt will develop in Ireland in the same way as it has done in the UK. To facilitate this, transactions may need to involve alliances with/the purchase of local servicing platforms.

Retail assets – secured

Selected mortgage/secured lending transactions over the last 18 months

Dates	Vendor	Size (mn)	Asset	Acquirer
July 2012	UKAR	£465	Mortgages	Virgin Money
June 2012	General Electric	€149	Subprime mortgages	Pepper Homeloans/ Goldman Sachs
April 2012	Bank of Ireland	£600	BTL	Coventry BS
March 2012	Permanent TSB	£6,000	BTL (capital home loans)	Aborted
October 2011	Bank of Ireland	£1,100	Mortgages	Nationwide BS

Source: Press search

The UK market for secured loan transactions

The market for secured loan transactions in the UK has also developed significantly in the last 12 months. Although important, these developments have not resulted in a significant volume of completed transactions; however, that trend may be about to change. We have seen continuing activity around non-performing mortgage assets, but here we focus on market for performing assets that has emerged more recently.

The bid-offer spread problem

A bid-offer spread has existed in recent years and continues to exist. It has primarily been driven by two concepts – accounting and return expectations.

- **Accounting** – banks are required to recognise provisions for incurred loss (i.e., where an indication of impairment has arisen); this has, in practice, resulted in a one year outlook in respect of loss. Buyers, however, are more concerned with expected loss and will therefore consider losses (or rather foregone cash flows) over a longer period.
- **Return expectations** – traditional buyers have been credit funds with equity return expectations. In many instances, low yielding assets, together with an absence of leverage, has resulted in offer prices below carrying values.

Retail assets – secured (continued)

New pools of liquidity emerging – will they narrow the bid-offer spread?

Three new pools of capital, above and beyond that provided by credit funds, have recently been addressing this market – building societies, new banks and long-only investors.

- **Building societies** – building societies are, similar to banks, in the position of needing to enhance levels of capital. With it proving very difficult to raise Tier 1 capital (given the ownership structure) their primary means of doing this is through earnings growth. However, back books were generally formed in 2005–09 when margins were thin and current prepayment rates are low, preventing a replacement of the back book with more profitable margin currently available at origination. Building societies can, however, enhance margin by acquiring higher margin portfolios, or by acquiring portfolios at a discount (which can unwind over time). This has resulted in an interest in portfolio transactions from a number of building societies – examples include Yorkshire Building Society's acquisition of the Norwich and Peterborough business, and Nationwide's and Coventry's acquisitions of Bank of Ireland portfolios.
- **New banks** – like building societies, new banks need to increase the yield on their portfolios – but for different reasons. OneSavings Bank, Aldermore, Shawbrook, Metro Bank and Virgin Money all either have or can generate a plentiful supply of liquidity. However, with repayment rates at very low levels across the market (due to both the attractiveness of existing products written in the pre-crisis years and the level of indexed LTVs that are, in many cases, in excess of acceptable underwriting levels), it is more challenging to originate assets. Acquisition is therefore again a credible strategy for underpinning balance sheet/ earnings growth.
- **Institutional investors** – typically institutional investors seek to deploy an element of their funds against credit-related products, and the demand for credit-related products is increasing given the low levels of return available on other assets. However, institutional investors are currently starved of credit opportunities – central bank liquidity operations (in particular funding for lending) have reduced the market supply of credit products (in particular RMBS). Despite this, with derecognition/deleverage a continued priority for many, it follows that institutional investors may start to deploy RMBS "technology" to acquire portfolios from banks.

Conclusion

All three of these buyer groups are seeking yield enhancement but are not seeking to become workout specialists. Performing non-conforming assets (i.e., those written on higher margins in the pre-crisis years) is where we expect the flows to be – BTL and self cert, in particular (and to a lesser extent subprime). The focus on performing reduces the first element of the bid-offer spread (accounting), and the return requirements of these buyer groups reduce the second element of bid-offer spread. We therefore expect further transactions of this ilk. Credit funds, however, in our view, remain the most likely buyers of non-performing assets.

The Irish market for secured loan transactions

- There has been very limited activity around retail secured loan portfolios. GE successfully sold its Irish assets and operations to Pepper Homeloans and Goldman Sachs.
- Given the levels of negative equity, the availability of forbearance, the lack of a clearing housing market (underpinning uncertain loss outcomes), the impact of the new personal insolvency framework and the lack of headroom for further losses in the banks, we do not expect there to be significant activity in respect of residential mortgage assets in the short term. However, given the banks' need to demonstrate progress in their workout of their problem loan portfolios and the tone of the Irish authorities in respect of their lack of appetite for continued forbearance in respect of delinquent BTL mortgages we consider this asset class may be increasingly active. These transactions are not straightforward however — evaluating the ability to enforce collateral in a market where this has traditionally been hard and the need to take a view on resale prices in a market that isn't clearing remain significant challenges.

Corporate loans

Single name and portfolio trades

With over US$60bn raised by opportunity funds and credit funds seeking to capitalise on the UK and European banks' deleveraging plans, corporate loan disposals are expected to feature prominently alongside real estate and retail loan sales.

Since 2008, we have seen more single name corporate loan trades coming to the market as banks seek to dispose of those exposures that have seen a significant deterioration in borrower credit quality and are considered to be non-core to the bank's plan. Performing loans that suffer from a negative carry cost as a result of legacy pricing are also being sold as banks seek to recycle capital and deploy it in areas that are accretive to their business.

Debt restructuring has also been a key driver for banks when assessing loan disposal strategies. In many cases they face a choice of either selling loans or effectively being forced into holding equity as a result of debt-for-equity swaps, with the cost of capital and ratio issues that result.

Buyers of corporate debt typically follow short-term strategies by seeking to capitalise on general seller distress to exit exposures quickly and at a discount to market value, with a view to holding to maturity and benefiting from increased yield. However, some acquisitions are driven by the acquirers' desire to take control of the underlying corporate entity and by acquiring the debt of a potential target; this can often provide buyers with the leverage they need to take control.

In 2011 the volume of corporate portfolio transactions took off with early sales of US-dollar-denominated loans driven by European banks responding to the poor liquidity in US money markets. Wells Fargo purchased US$6bn of portfolio loans and funding commitments from WestLB and US$9.5bn of oil and gas loans from BNP Paribas, for example.

During 2012 we saw significant activity by Lloyds with the sale of circa £500mn of corporate debt comprising 30–40 single name largely performing senior loans sold to Sankaty and circa £1.2bn of loans comprising 40 single name performing senior and junior loans and equity positions created from previous restructurings sold to TPG and Goldman Sachs.

Corporate loans (continued)

Other banks that have been active include Allied Irish Bank with the sale of a portfolio of leveraged and corporate loans to Bank of America with a face value of €300mn.

Looking forward, there are reports that the Irish Bank Resolution Corporation is considering selling up to €2bn of corporate loans.

While portfolio trades may be an easier way of putting larger amounts of capital to work, sales have been frustrated by large volumes of incomplete data, complex auction rules and subsequent approvals required, particularly where credits have already been through a debt-for-equity swap and pre-emption rights exist.

In addition to the large number of on-balance-sheet disposals, we also expect either the sale of loans or the sale of the underlying collateral of many structured debt products such as CLOs written pre-2007 as a result of the inherent inflexibility of many of these lending structures preventing debt extensions, restructurings or even reinvestments.

The consensus view is that transactions in European leveraged loans (both single names and portfolio) will increase as the "refinancing wall" peaks in 2015.

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