

European non-core asset market update

March 2021



European trends over the past 10 years and how is the market different now

Many commentators have characterised the COVID-19 crisis as potentially causing a 'second wave' of non-performing loans (NPLs), equivalent only to the aftermath of the global financial crisis. In this issue of our market update, we comment on:

1. How asset quality has developed since the global financial crisis and the likely impact of COVID-19
2. Our view on the levels of non-core asset transactions for the next 3-5 years, including key drivers as well as obstacles.

1. Impact of the pandemic on asset quality:

Following the spike in NPLs resulting from the global financial crisis, when total NPLs in Europe exceeded EUR 1.2 trn¹, NPL stocks more than halved to less than EUR 600bn as at Q2 2020. This was mainly as a result of the significant actions undertaken by the banks. However, based on the analysis below we can see that:

- Even before the pandemic hit the rate of reduction was starting to decrease significantly, resulting in marginal, if any, decreases in NPL ratios
- For some of the European countries, especially in Southern Europe, the NPL stock remains significantly above where it was prior to the global financial crisis, more than 10 years ago.

¹ PwC estimates and analysis

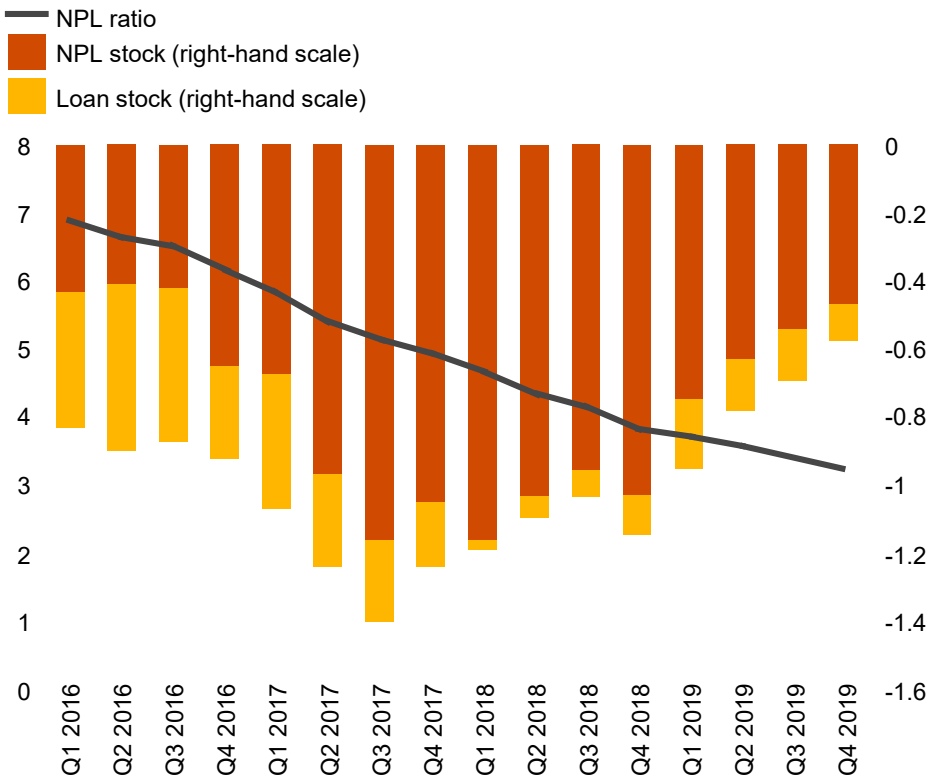


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NPL ratios declined further, but reductions slowed on the back of lower sales and write-offs, while new NPL inflows increased only slightly up to end 2019.

Developments in NPL ratios and factors contributing to annual changes

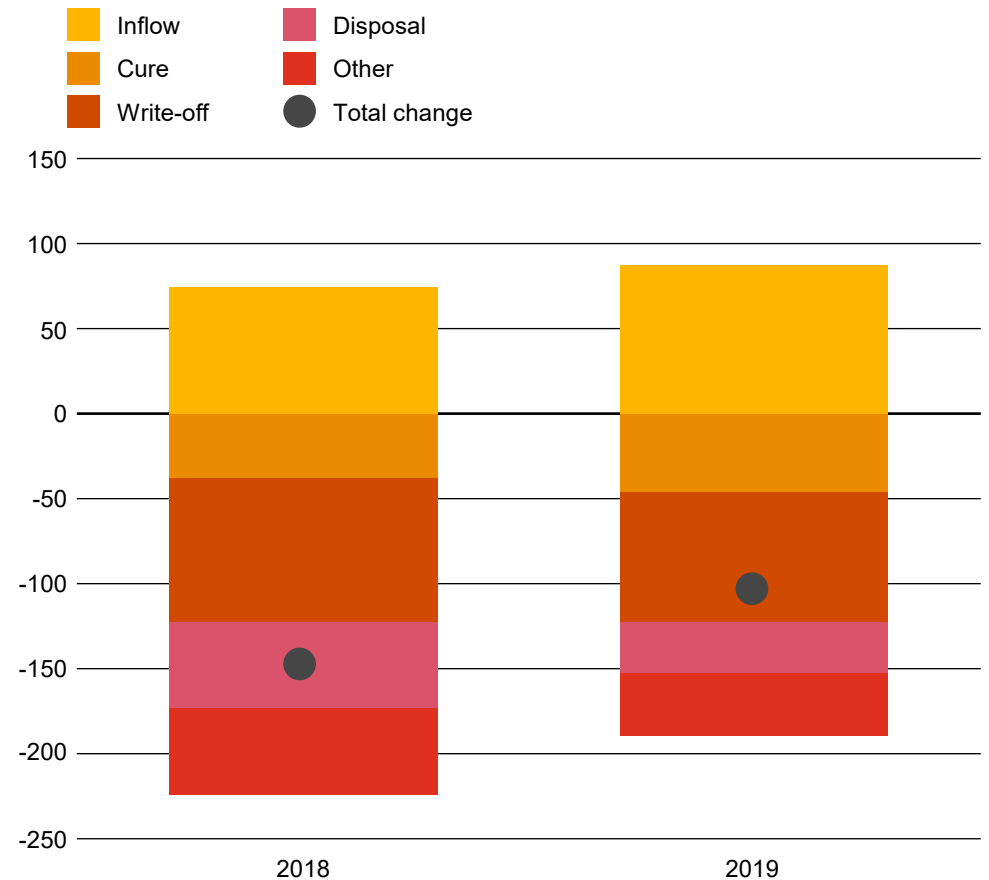
(Q1 2016-Q4 2019, ratio, percentage point contribution to annual changes)



Sources: ECB supervisory statistics and ECB calculations
 Note: Based on a sample of 116 SIs

Decomposition of changes in NPL stock

(2018-19, annual changes in € billions)



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Looking forward, we would not be surprised if NPL levels across Europe exceed the EUR 1trn level again, negating the efforts undertaken by the banks over the last 7-8 years. The ECB has estimated that, in a severe but plausible scenario, they expect that NPLs in the Eurozone banks could reach 1.4trn¹.

This is significantly above the level reached in the aftermath of the global financial crisis.

Furthermore, the EBA, in its recent risk assessment report², noted that it was expecting a significant deterioration in credit quality over the following quarters. An early indication of that is the fact that forborne loans in the Eurozone stood at EUR 360bn as at June 2020. At the same time Stage 2 loans, which are considered an early indicator of non-performing loans, increased to EUR 1.2trn, which was 23% higher than in June 2019.

Based on our review of the additional levels of provisioning, as disclosed by a sample of the largest European banks as part of their Q2 earning results, we can see that:

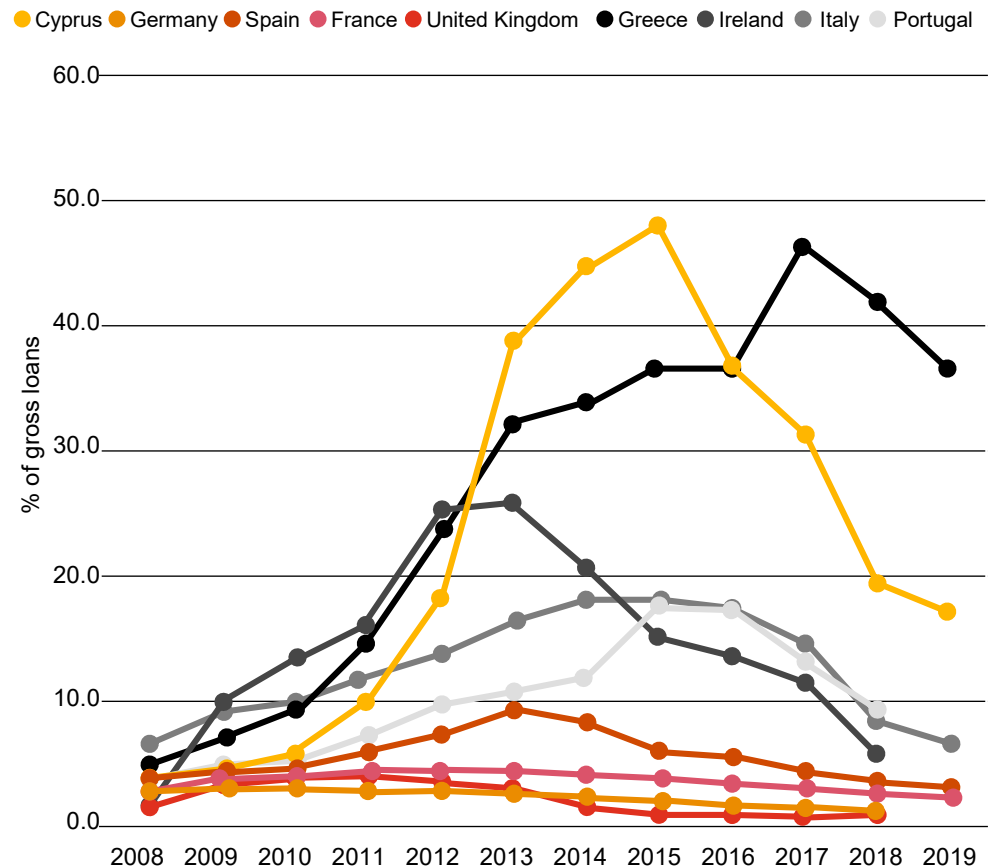
- Cost of risk has increased significantly. Our review covering a sample of 22 large European banks showed that total provisions for the first half of 2020 exceeded EUR 40bn. This represents almost 7% of the European stock of NPLs which stood at EUR 587bn as at June 2020.
- UK and Spanish banks appear to have taken relatively larger provisions to date when compared to banks in other European countries.. We expect that, similar to the period 2009-2012, UK and Spain will be two of the markets that will experience higher levels of non-core asset transaction activity first.
- The current provisioning levels are, to a large extent, still based on estimates regarding future defaults rather than actual loss experience. The true levels of defaults and losses will be highly dependent on the shape of the economic recovery and how the various government support schemes evolve. We expect that it will take another three to four quarters before banks have a clearer view on whether these borrowers are truly performing.
- This time round, the impact of the pandemic on asset quality appears to be less concentrated in large commercial real estate backed loans and more widespread among all types of lending such as corporate, SME etc.

¹ Source: Financial Times, letter from Andrea Enria, chairman of the supervisory board of the European Central Bank

² EBA risk assessment of the European banking system, December 2020

NPLs as a % of Gross loans

Source: Worldbank



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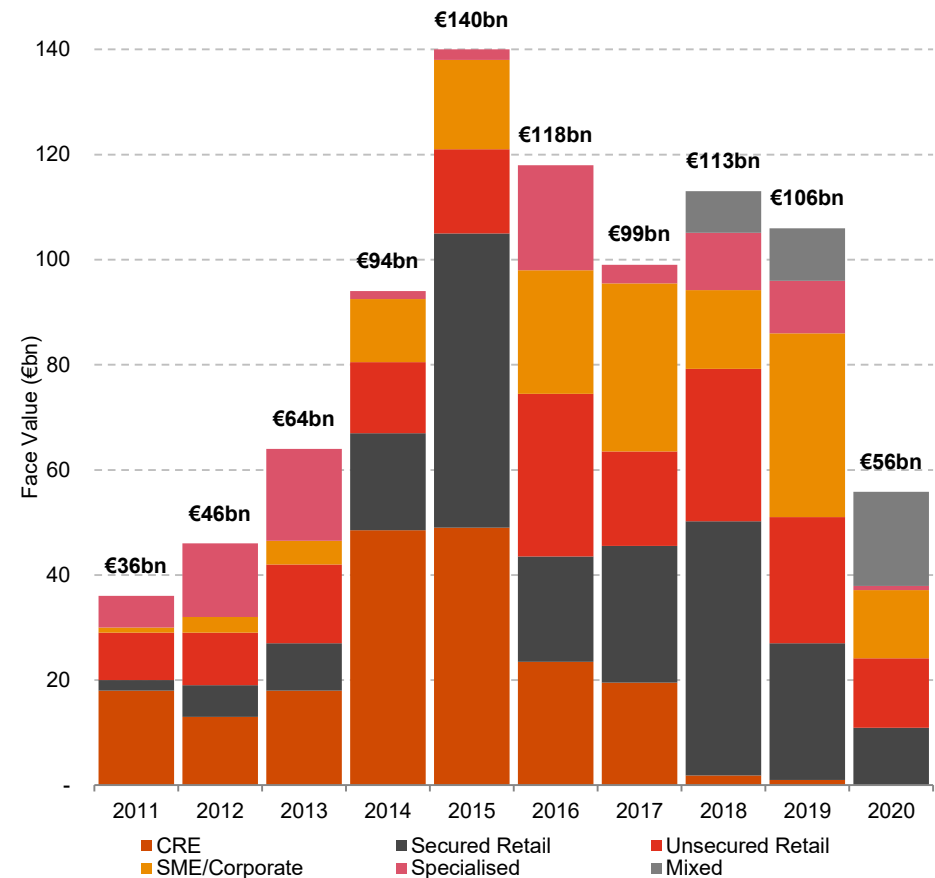
2. Our views on the non-core asset market going forward:

PwC has maintained a comprehensive database of performing and non-performing loan transactions since 2010. Our data shows that, even though the global financial crisis started in 2008, the European loan portfolio market did not really start experiencing material levels of activity until 2012 – 2013, which was three to four years after the crisis.

We consider that this was a direct result of:

- The European banks being undercapitalised, compared to their current state, at the beginning of the crisis
- The European non-core asset market being in its infancy, as banks, investors and advisors were relatively inexperienced in these types of transactions. Furthermore, the infrastructure in place, such as 3rd party servicing capacity, independent real estate and financial advisors was below the scale required in order to manage the amount of non-core and NPL assets that was sitting in the bank balance sheets.

Portfolio transactions by asset class €bn 2011 to 2020



Source: PwC analysis

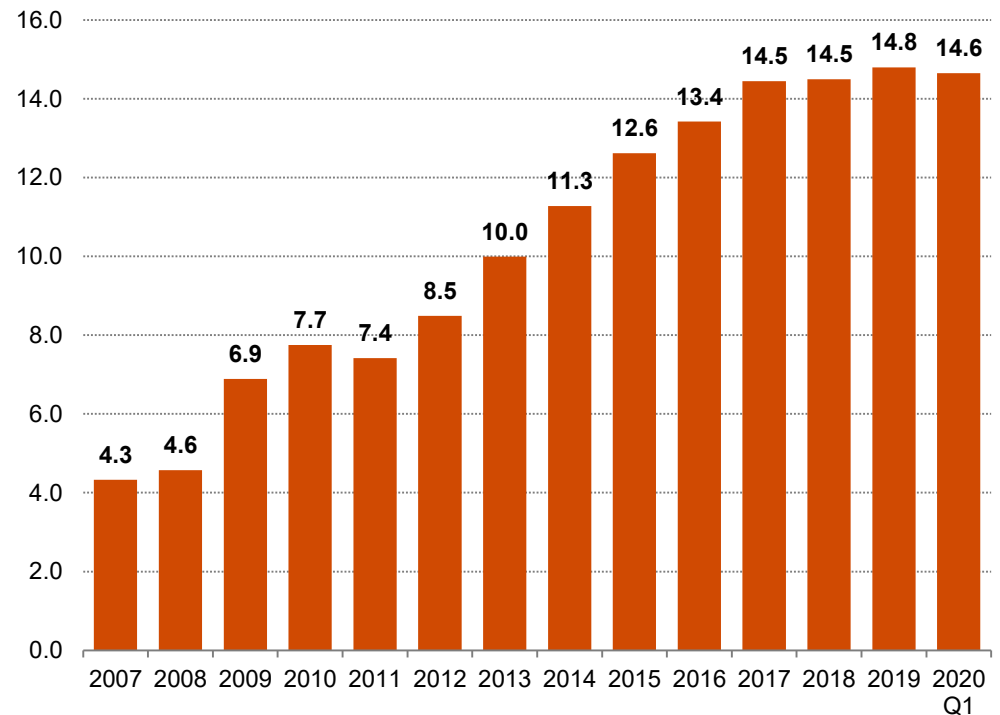
European trends over the past 10 years and how is the market different now

We consider that the European non core asset market is now more mature and therefore ready to address the potentially significant increase in NPLs. Consequently, and judging from the increased number of transactions that our team is working on, we consider that the level of transactions will slowly increase over the next 12 months with peak levels of activity for a number of years 2022 onwards

Below we have set out the key factors that we believe will drive the European non core asset market for the next 5 – 7 years:

- **(+) Banks are much better capitalised now than they were 12 years ago:**
 - A key driver behind the delay in the uptick in transactions following the Global Financial Crisis was the weaker, compared to their current situation, capital position which discouraged banks from proceeding with any transactions that gave rise to any haircuts in capital. We expect that due to the stronger capital position (see graphs below) European banks will be much more proactive in addressing non core parts of their business this time round.
 - Our team is currently involved in a number of loan sales and forward flow transactions representing a mix of old (i.e. pre – Covid -19) transactions that were put on hold at the beginning of the lockdown as well as new situations that have arisen as a result of the crisis.

Aggregate CET1 capital ratio of major UK banks since the financial crisis



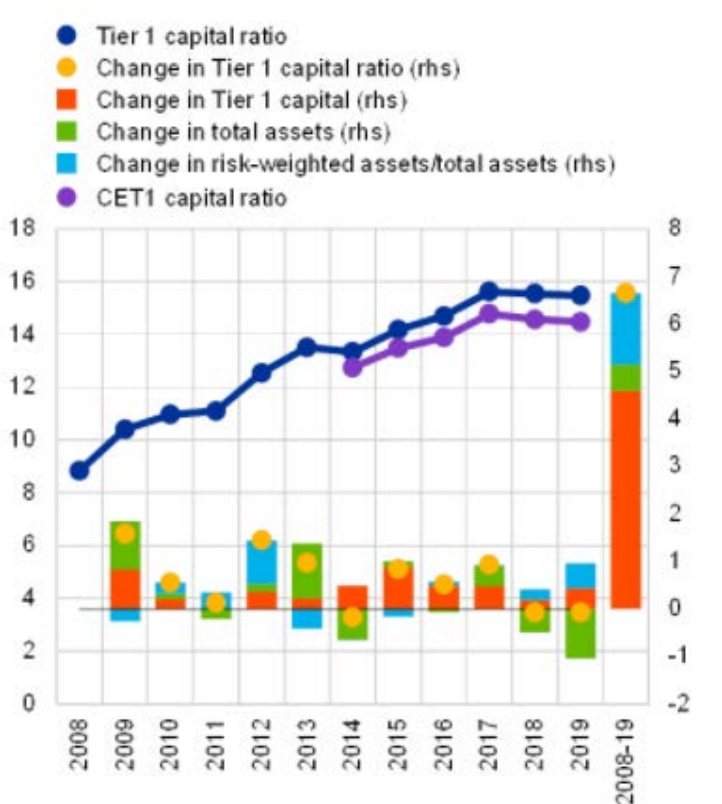
Source: Bank of England Interim Financial Stability Report May 2020

Bank of England Interim Financial Stability Report May 2020 (PRA regulatory returns, published accounts, Bank analysis and calculations).

European trends over the past 10 years and how is the market different now

Long-term developments in euro area banks' Tier 1 capital ratios with contributing factors and CET1 capital ratios

(2008-Q3 2019, percentages, percentage changes and percentage point contributions)



Sources: ECB financial stability review

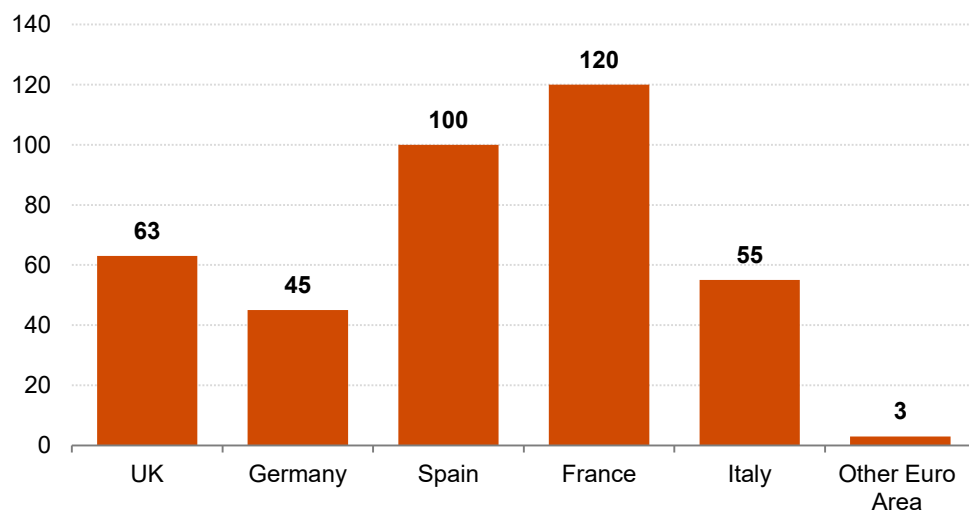
- **(+) Banks and investors are now much more experienced in non-core asset transactions:**
 - Based on our internal database of non-core asset transactions we estimate that, since 2011, banks and investors have transacted on more than 1,800 loan portfolios or related transactions with a face value of €850bn. As a result, a significant number of European banks and investors have developed extensive transactional expertise that will allow the pursuit of a non-core asset disposal strategy much quicker than in the aftermath of the Global Financial Crisis.
- **(+) The legal framework and market infrastructure is now much more mature that in the period 2008 to 2011:**
 - The legal recovery framework (bankruptcy, foreclosure etc) in most European jurisdictions is now much more tested and reliable than in the period before 2008. In addition, the European servicing landscape is now much more developed following years of significant banking carve outs and consolidation.
- **(+) Banks are looking at more comprehensive solutions to optimise their balance sheet**
 - Based on the range of the engagements that our team is working on we see that banks are looking at a number of ways, over and above loans sales, to optimise their balance sheets.
 - For example, we are currently discussing significant risk transfers with a number of medium and small size banks across Europe, usually operating under the standardised approach. All of these players are currently exploring significant risk transfers as a way to save and redeploy capital and increase their Return on Equity (RoE).
 - As a result of increased appetite from new investors (such as insurers and large credit funds) we see the SRT market changing from a traditionally relatively private market, dominated by a small group of specialist funds dealing with a limited number of issuing banks, to a much more widely accepted way of capital management by an increasing number of European banks.

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- **(-) Increased level of government support:**

- The COVID-19 pandemic has initiated unprecedented levels of government support across Europe. For example, in August/September 2020, as it can be seen from the graph below, the largest 5 economies in Europe had partly guaranteed EUR 383bn of loans, with the majority of them granted between April and June 2020.
- We believe that the significant number of government guarantees supporting the exposures below, is likely to create additional complexity in the market especially in relation to the most effective way to collect any loans with a government guarantee that will become delinquent.

Take up of loans under public guarantee schemes (EUR bn)



Sources: ECB, ECB, UK government, Data as at April – August (UK data is as at September and includes approved rather than taken up balances.)

Looking forward, we estimate that NPL portfolios with a face value of around €150bn will trade in 2021 and 2022 – with probably around a third of this in 2021 and the remainder in 2022. When factoring in performing loan sales which occur for strategic reasons, the total face value to be traded over the next two years may be slightly higher than this. Beyond 2022 we would not be surprised if levels of activity remained at the ‘plus €100bn’ a year for several years.

From our market discussions we know that buyers are well funded and looking for investment opportunities. A major consideration for banks selling will be: when is it best to sell – is there benefit in going earlier when there will be lower volumes competing for the attention of the big funds who account for the vast majority of all trades or will pricing improve as the impact of the pandemic on borrowers becomes clearer?

Contacts

Austria

Bogdan Popa

+43 699 1630 5330
bogdan.petre.popa@pwc.com

Bulgaria

Bojidar Neytchev

+35 929 355 288
bojidar.neytchev@pwc.com

Croatia

Sinisa Dusic

+38 516 328 844
sinisa.dusic@hr.pwc.com

Cyprus

Stelios Constantinou

+35 725 555 190
stelios.constantinou@pwc.com

Czech Republic and Slovakia

Petr Smutny

+42 025 115 1215
petr.smutny@pwc.com

Denmark

Bent Jørgensen

+45 39 459 259
bent.jorgensen@pwc.com

France

Hervé Demoy

+33 156 577 099
herve.demoy@pwc.com

Germany

Christopher Sur

+49 699 585 2651
christopher.sur@pwc.com

Thomas Veith

+49 699 585 5905
thomas.veith@pwc.com

Jörg Jünger

+49 699 585 2707
joerg.juenger@pwc.com

Greece

Thanassis Panopoulos

+30 210 687 4628
thanassis.panopoulos@pwc.com

Hungary

Csaba Polacsek

+36 14 619 751
csaba.polacsek@pwc.com

Ireland

David Tynan

+353 1792 6582
david.tynan@ie.pwc.com

Italy

Pierpaolo Masenza

+39 065 7025 2483
pierpaolo.masenza@pwc.com

Fede Pascuzzi

+39 028 064 6323
fedele.pascuzzi@pwc.com

Matteo D'Alessio

+39 027 785 272
matteo.dalessio@pwc.com

The Netherlands

Jessica Lombardo

+31 887 925 060
jessica.lombardo@pwc.com

Peter Wolterman

+31 887 925 080
peter.wolterman@pwc.com

Wilbert van den Heuvel

+31 887 923 816
wilbert.van.den.heuvel@pwc.com

Poland

Pawel Dzurak

+48 227 464 697
pawel.dzurak@pwc.com

Portugal

Antonio Rodrigues

+35 121 359 9181
antonio.rodrigues@pwc.com

Serbia

Marko Fabris

+38 111 330 2137
marko.fabris@rs.pwc.com

Spain

Jaime Bergaz

+34 915 684 589
jaime.bergaz@pwc.com

Guillermo Barquin

+34 915 685 773
guillermo.barquin.orbea@pwc.com

Pablo Martinez-Pina

+34 915 684 370
pablo.martinez-pina@pwc.com

Richard Garey

+34 915 684 156
richard.garey@pwc.com

Sweden

Per Storbacka

+46 855 533 132
per.storbacka@pwc.com

Turkey

Serkan Tamur

+90 212 376 5312
serkan.tarmur@tr.pwc.com

Kadir Köse

+90 212 355 5323
kadir.kose@tr.pwc.com

Ukraine

Oleg Tymkiv

+38 044 4906 773
oleg.tymkiv@ua.pwc.com

United Kingdom

Richard Thompson

+44 7711 495 236
richard.c.thompson@pwc.com

Robert Boulding

+44 7970 829 669
robert.boulding@pwc.com

Chiara Lombardi

+44 7557 050 155
chiara.p.lombardi@pwc.com

Panos Mizios

+44 7739 877 229
panagiotis.mizios@pwc.com

Simin Varghese

+44 7803 456 036
simin.z.varghese@pwc.com

North America

Mitchell Roschelle

+1 646 471 8070
mitchell.m.roschelle@pwc.com

Asia Pacific

Ted Osborn

+85 222 892 299
t.osborn@hk.pwc.com

James Dilley

+85 222 892 497
james.ha.dilley@hk.pwc.com

Huong Dao Thi Thien

dao.thi.thien.huong@vn.pwc.com

Lee Chui Sum

+60(3) 2173 1188
chui.sum.lee@my.pwc.com

Michael Fung

michael.fung@au.pwc.com

Masaya Kato

+81 906 512 4999
masaya.kato@pwc.com

Latin America

Carolina Pimenta

+55 11 3674 2532
carolina.pimenta@pwc.com

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