QUALCO

NPL Outlook Europe 2021

How data-driven digital technology will help manage the tide

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DDC Financial Group

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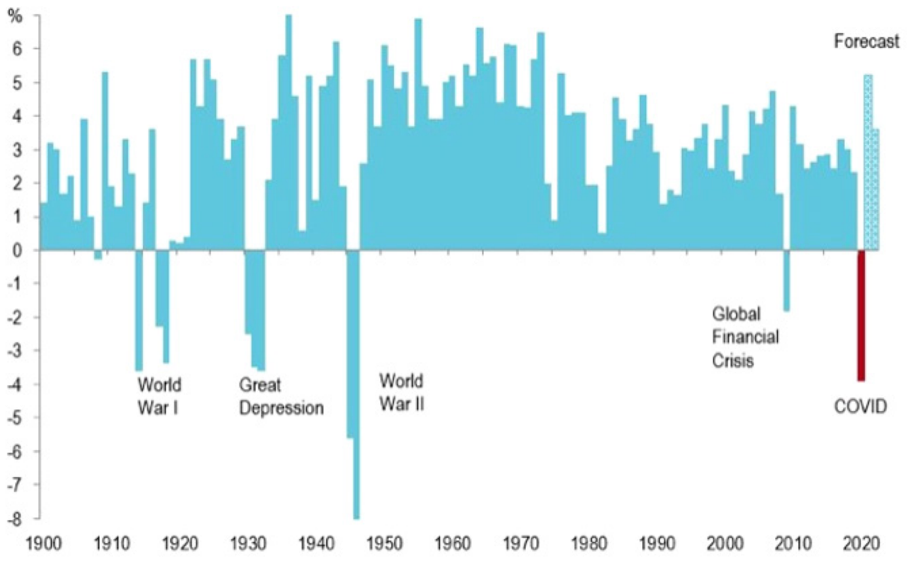
EXECUTIVE SUMMARY

2020 challenged all of us. The most severe economic contraction in decades triggered vast monetary accommodation and fiscal support packages that altered the investment landscape. The COVID-19 shock is unique in both its magnitude and sector impact. Unlike prior recessions, the services sector has been most hard hit by the downturn. The recovery will remain incomplete until the services sector normalizes. And the services sector will not normalize until we adjust to living with COVID-19.

Largest decline since WWII

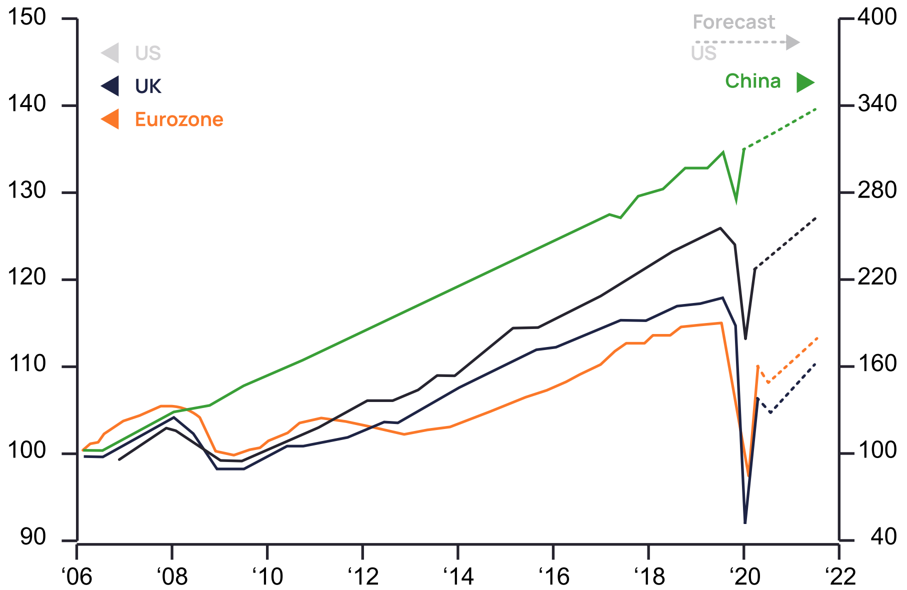
Graph shows change in world gross domestic product (inflation-adjusted, in %)



Data as at 23 November 2020. Source: Haver, IEA, Bloomberg, BNP Paribas Asset Management

Real GDP Levels

Index level, released to 100 at 1Q 2006



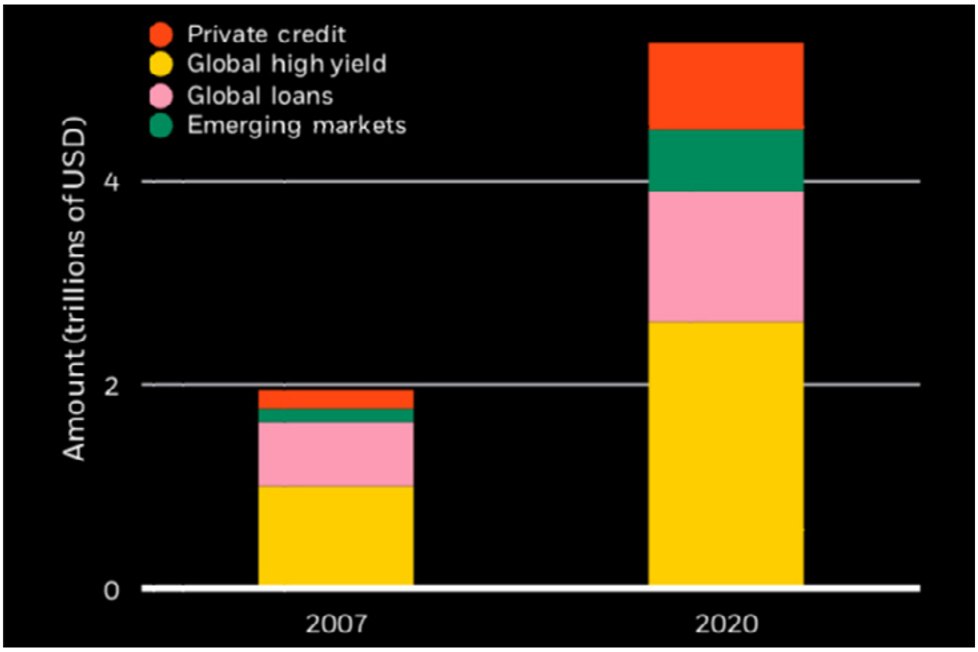
Source: BEA, Bloomberg, Eurostat, National Bureau of Statistics of China, ONS, J.P.Morgan Asset Management, Forecasts are from Bloomberg contributor composite. Data as of 17 November 2020.

GLOBAL DEBT

The huge rise in corporate leverage combined with an uncertain economic outlook increases the chances that debts will not be repaid in full or on time. Defaults have already picked up sharply. The global debt load comprised of both private and public debt, rose by $24 trillion last year, making up over a quarter of the $88 trillion rise over the past decade, now stands above $281 trillion. Almost no one expects the economy to have fully recovered by the end of 2021, with some estimates indicating that **global debt could exceed $360 trillion by 2030.**

PRIVATE DEBT

Private Debt continues to attract strong demand from global investors who have essentially gone looking for what they cannot find in public markets to meet their evolving needs. The European demand for private capital has extended to lending and, in this environment, European private credit managers and their investors, have demonstrated their commitment and expect to provide businesses with over $110 billion of new capital in 2021.



Source: BLACK ROCK RESEARCH INSTITUTE

EUROPEAN NON-PERFORMING LOANS & REGULATIONS

In an adverse scenario, the ECB has estimated that the amount of non-performing loans (NPLs) in the Euro area might reach €1.4 trillion by the end of 2022, while the Eurozone NPL ratio is expected to increase from 3.1% in Q4 2019 to 4.7%-5.4% by the end of 2021. This would put between €255-380 billion of additional NPLs on Eurozone banks' balance sheets by the end of 2021.

On December 16th 2020, the European Commission on Coronavirus response issued the guideline "Tackling non-performing loans (NPLs) to enable banks to support EU households and businesses" in which it identified only 21 of the 113 significant institutions were able to forecast the level their NPLs will have reached by the end of 2021. The guideline concludes that **"history has shown us that it is best to tackle NPLs early and with decisive action, while ensuring robust consumer protection, to allow the banking sector to play its role in supporting the economic recovery".**

THE VEIL WILL SOON BE LIFTED

As furlough and moratorium schemes conclude, account receivables will be placed under severe stress and businesses can expect to see arrears, provisions and bad debt levels increase at unprecedented rates. Only when that support is withdrawn will the veil be lifted.

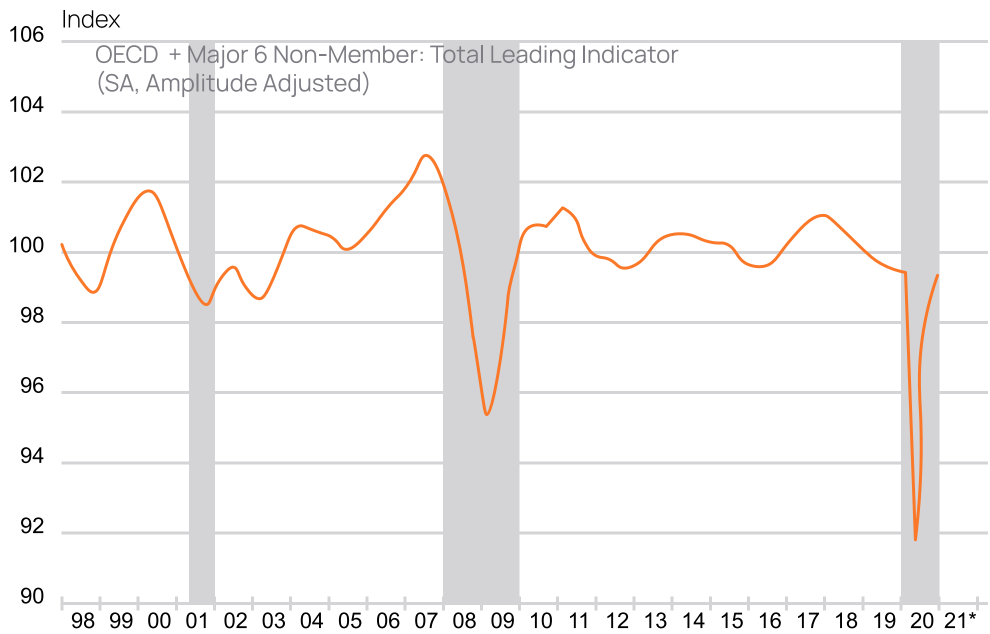
HOW DOES TECHNOLOGY HELP TO AVOID CREDIT CRUNCH AND LOSSES?

Traditionally, NPL management has not been a focus for digital technology but this pandemic crisis has clearly propelled the world into a very different future. At the same time, creditors need to reconsider vulnerability anew as millions of people are now experiencing financial insecurity and, in many cases, for the first time. As banks, lenders, and collections functions are dealing with a unique set of challenges, new tools are required to ensure fair customer outcomes and satisfaction.

In that context, leveraging analytics to better understand customers' circumstances and suggest appropriate forbearance options that can then be delivered via digital mediums such as self-service portals and chatbots is now a necessity.

Savvy business leaders are investing now in a combination of operations automation and advanced analytics underpinned by a comprehensive collections platform to help mitigate this expected surge in impairment. Automation, on one hand, has a clear, direct impact on operational efficiency achieved by 360-degree customer views, guided scripts, dialer, and digital channel integration, while advanced analytics on the other hand builds on operations to improve effectiveness through optimal segmentation, contact channel treatment selection, and action prioritisation by leveraging data recorded in the operations platforms and combining it with additional sources where appropriate.

V-Shaped Recovery in Global Leading Economic Indicator Signals Solid Growth Recovery in 2021

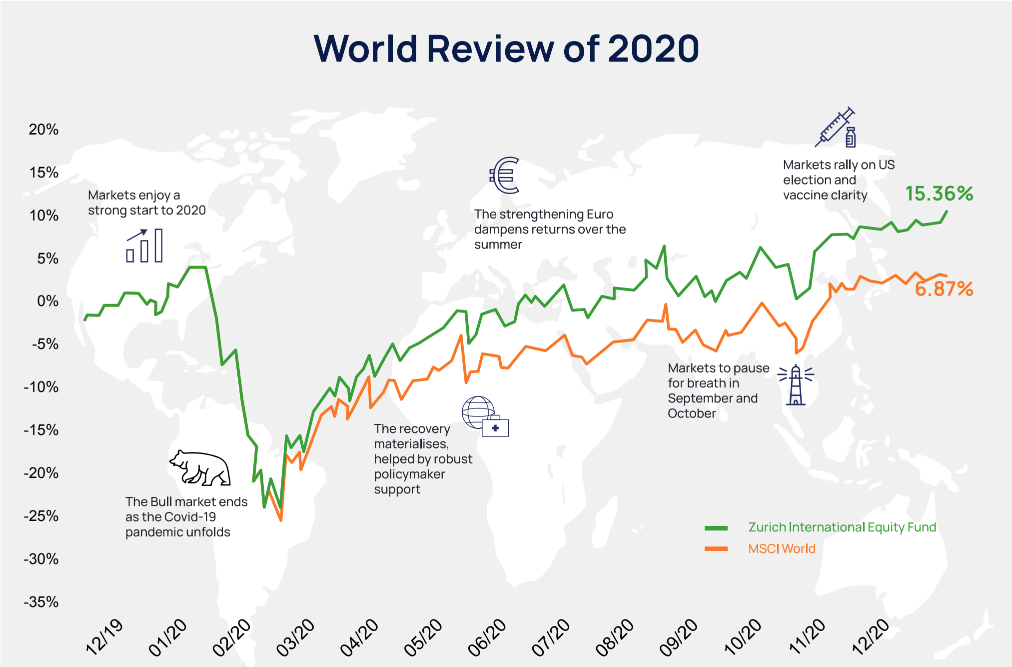


Estimate Sources Organisation for Economic Cooperation & Development/Haver Analytics. Data as of December 8 , 2020.
Past Performance is no guarantee of future results.

MACROECONOMIC VIEW

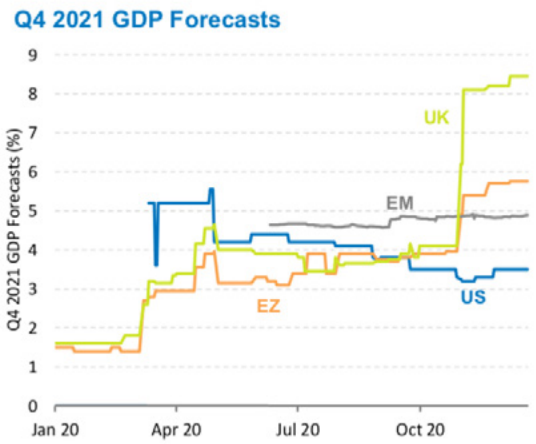
There are many words to describe financial markets in 2020, but "normal" certainly is not one of them.

In **Europe**, a massive EU recovery fund fiscal package (€750 billion) continues to be held up, while in parallel, economic growth in the Eurozone was projected, by the Organisation for Economic Co-operation and Development (OECD), to register a contraction of 7.5%. **In 2021, after a possible further decline in the first quarter caused by the many restrictions in place, a recovery is likely in H2 depending on the roll-out of vaccines, with the real GDP advancing between a projection of 3-4%.**



UK

The UK is responding to the economic situation by increasing fiscal and monetary support that includes extending the Job Retention Scheme to the end of March and increasing bond purchases authorized by the Monetary Policy Committee. The OECD in its recently released Economic Outlook in December 2020, projects that the UK economy will be among the hardest hit by the pandemic of the major economies.
Following a decline of over 11% in 2020, this year and assuming a limited trade deal, the UK's real GDP may advance by just 4.2% in 2021 despite a continued sizable decline in the first quarter. By the end of next year, the UK economy is expected to be more than 6% below where it was at the end of 2019.



In March 2020, Rishi Sunak announced the Covid Corporate Financing Facility "CCFF" scheme to support investment grade businesses with short-term liquidity schemes, as well as the Coronavirus Business Interruption Loan Scheme "CBILS" for SMEs, which evolved into the larger Coronavirus Large Business Interruption Loan Scheme "CLBILS".
In November, however, the Government announced that BBLS borrowers could 'top up' their existing loan under the scheme if they had originally borrowed less than the maximum amount

available to them: staff estimate that this could accommodate an additional £5 Bn of lending in aggregate. Q2 witnessed an even stronger contraction at -21.5% as lockdown measures were introduced. Although the contraction slowed down in Q3 caused by the major relief package made available by the Economy Minister, it was still significant at -9%. **Across the UK, Germany, France, Italy and Spain, €542.9 billion of loans have been approved, however, the UK schemes have been largely off-limits for PE-owned businesses. In the UK – £141.8 billion / €156.0 billion of state-guaranteed loans were approved across multiple schemes.**

The UK has managed to keep the unemployment rate low through furlough schemes and other measures, which has led to only marginal increases in the unemployment rate and was reported at 4.8% in the latest reading in September and had been prorogued till April 2021.

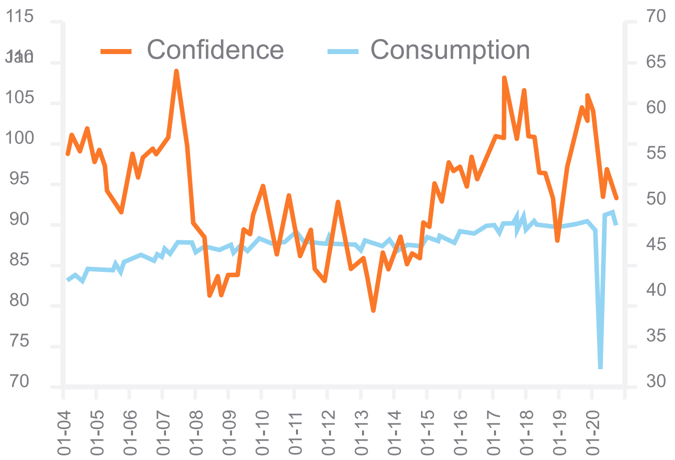
In the UK, it is estimated that £35 billion of unsustainable debt will arise from the loans issued in response to Covid-19 and insolvencies are likely to increase from their current low levels. This illustrates the size of the refinancing challenge that most economies are likely to face in 2021 and the demand for capital that will exist among SMEs and other businesses. Over the course of 2020, major UK banks' and building societies' aggregate Common Equity Tier 1 capital ratio increased to 15.8% at the end of September, which is over three times higher than at the start of the global financial crisis. Over this period, they have provisioned £20 billion of credit losses, although the effect on the capital ratio is reduced by the transitional relief of IFRS 9. Nevertheless, the major UK banks can absorb credit losses in the order of £200 billion, much more than would be implied if the economy followed a path consistent with the MPC's (Marginal Propensity to Consume) central forecast.

FRANCE

Household confidence will play a key role in France's economic recovery from the Covid-19 crisis. But unlike consumption, confidence never recovered to its pre-crisis level even when the first lockdown was lifted. After a short-lived rebound in June, and with the implementation of a second lockdown in November, confidence has deteriorated severely.

During the first lockdown, the timely announcement of generous fiscal support measures amounting to EUR 120.7 billion of state-guaranteed loans (Prêts Garantis par l'Etat –'PGE') spread across approximately 588,000 borrowers reassured households, helping to prevent a major confidence shock despite the historical drop in consumption.

Consumer confidence (lhs) and consumption (rhs) - EURbn



COVID-19 data m/m change

Date	Consumption (%)	Change std dev.	Consumer confidence (100 basis points)	Consumer Change std dev.
03-20	-16.7%	-17	-0.9	-1
04-20	-18.7%	-20	-8.5	-4
05-20	37.5%	30	-2.5	-1
06-20	10.7%	9	3.7	2
07-20	-0.6%	-1	-2.0	-1
08-20	2.2%	2	0.0	0
09-20	-4.4%	-5	1.1	1
10-20	3.7%	3	-1.7	-1
11-20	n.a.		-3.3	-2

The "confidence effect" usually explains around one-third of the consumption gains in France, but this relationship seems to now be temporarily broken. Household confidence in France has been held back by continued uncertainty over the sanitary and economic outlook, as well as growing fears of unemployment. Indeed, after a short-lived recovery in Q3, the unemployment outlook sub-component of the headline confidence indicator has been deteriorating continuously.

France is the third country in the EU (after Austria and Germany) known as being saving champions, even though returns on financial assets are much higher. At just under EUR 2,000 per capita saved over the last decade, these additional saving efforts are much lower. Nevertheless, the savers on both sides of the Rhine seem to be more similar in their saving ambitions, or stinginess, than often assumed.

In France, continued fiscal support will be vital for companies in view of the deteriorated sanitary situation and the expected cautious exit from lockdown, which will result in a milder recovery of economic growth in 2021 (+6.2%).

GERMANY

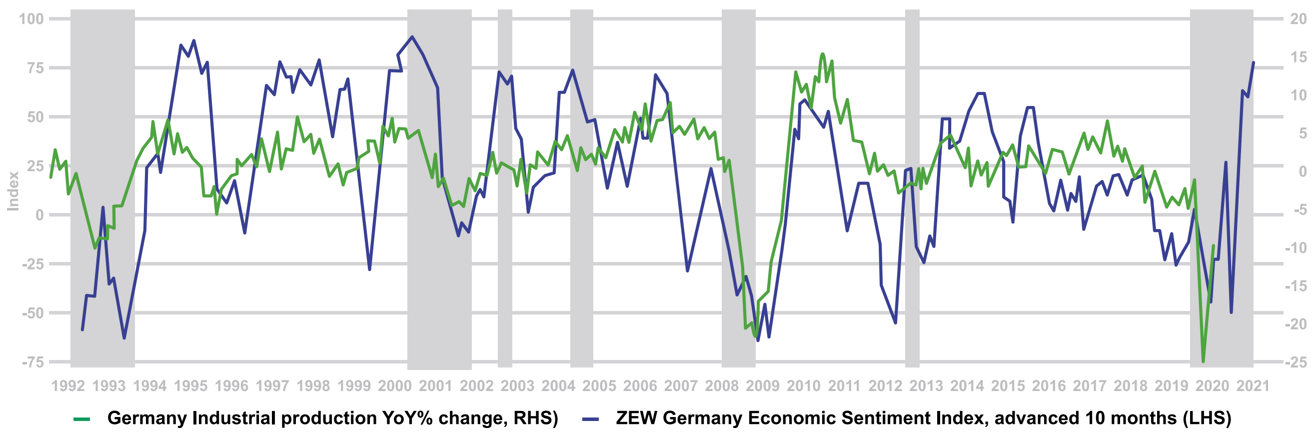
Since the summer of 2020, industrial activity has decoupled from the service sector and other lockdown-hit activities. The German economy contracted by -5.0% in 2020, suggesting that economic activity held up relatively well in the final quarter of the year despite the second lockdown. EUR56.9bn of state-guaranteed loans have been approved, across approximately 137,100 borrowers.

The nature of the 'smart lockdowns' is clearly one important driver of this divergence. Also, the German manufacturing sector seems to benefit from the strong and continuing recovery of the Chinese economy. **Of the €542.9 billion of approved loans across the UK, Germany, France, Italy and Spain, Germany accounts for €56.9 billion of state-guaranteed approved loans, across 137.1k borrowers.**

On the fiscal side, the Kurzarbeit has already been extended until the end of 2021 for a total cost of €40 billion. However, the modalities and bureaucratic hurdles should be revisited and adjusted to improve take-up. This concerns, in particular, the corporate bridge support and the emergency aid for micro-businesses and sole traders, for which a combined €75 billion have been set aside but only €15 billion used. Further fiscal relief is crucial, to provide viable firms with more breathing space.

In Germany, the investment income is not sufficient to reach one's own saving goals: savings from earned income have to be added. With just under €10,000 per capita over the last ten years, German households have fully lived up to their reputation as the "world champions of saving". These saving efforts explain why the Germans are still achieving decent growth in financial assets despite low returns. At the same time, however, that also means that over the last ten years there was a total "shortfall" of around €800 billion in consumption in Germany, or at least around 5% of annual consumer spending.

German ZEW sentiment expectations and German industrial production



ITALY

Notwithstanding the strong rebound recorded on the reopening of the economy, Italian GDP at the end of Q3 2020 was still 4.7%, lower than in pre-Covid times, and the statistical carryover for 2020 remains a scary -8.3%.

Confidence data highlights vulnerability in service sectors. This has been reflected in November confidence data, which showed a divergence between a sharply softening services component and more resilient manufacturing. Households also seem to be feeling the brunt of the second wave: after temporarily peaking in September, consumer confidence has lost ground, falling more than three points in November. Increasing concerns about future unemployment are apparently eating into households' willingness to purchase durable goods. **In Italy, an aggregate of €105.5 billion of state-guaranteed loans was approved by the end of 2020.**

2020 registered a contraction of Distressed transactions compared to the previous year due to the uncertainty of the evolution of the pandemic, which caused the postponement of many deals. Not the best omen for fourth-quarter spending.
Intesa Sanpaolo Bank in 2020 was one of the most active players in the market, also due to the merger with UBI, accumulating €12 billion of which €7 billion and €5 billion were made up by Intesa and UBI respectively in distressed assets. Italian Banks, in response to market and regulatory pressure, have halved the total stock of NPLs (€130 billion in H1-2020 vs €341 billion in 2015) and, at the same time, they have set up NPL platforms and organizational controls that will allow to manage non-performing loans more quickly and efficiently and thus face the incoming economic crisis in a more resilient way.

Italy has one of the largest total amounts of NPLs in Europe, though this is partly explained by the size effect. Turning to the NPL ratio, it is higher than the European Banking Authority, an indicative benchmark of 5% in Italy.

SPAIN

The renewed Covid-19 restrictions have obviously harmed demand, particularly in the tourism and hospitality sector. New orders in the manufacturing sector in Spain dropped at the fastest rate since May while new export orders also fell for the first time in three months. Production volumes slipped only marginally.

Spain and Italy were the first two countries in Europe to be significantly affected by the coronavirus outbreak. As a result, Spanish companies have been operating under more stringent and lengthy lockdown measures than those in many other European countries. These actions have resulted in a spike in unemployment and a slump in consumer spending and it is still expected that corporate credit quality will decline further because of the macroeconomic recession and subsequent impact on consumer confidence and disposable income. In Spain, €103.8 billion of state-guaranteed loans across approximately 841k cases were approved.

Banks in Spain have the largest credit exposure to those sectors that we expect to be hit the hardest by Covid-19, including transportation & storage, accommodation & food service, art, entertainment & recreation, retail & wholesale, industry, and construction. In the final quarter of 2019, these sectors already boasted large NLP ratios at the EU level: construction reported the highest NPL ratio (15%) while accommodation & food services, as well as arts, entertainment & recreation, also had elevated NPL ratios (9% and 8%, respectively). Around 60% of Spanish real GDP is generated by internal private consumption, and therefore, the consumption deficit will have a substantial effect on Spanish real GDP growth in 2020. This, added to the importance of the tourism sector, which accounts for about 12% of GDP, will lead to a material contraction in GDP of about 8.0% in 2020.

MONETARY POLICY

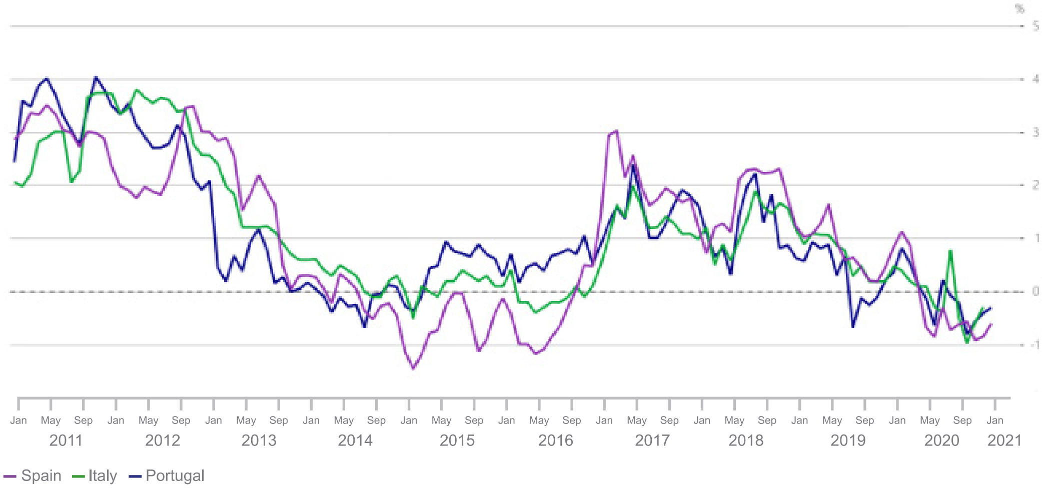
The **European Parliament** reached an agreement with EU member states over the creation of a €1.8 trillion ($2.1 trillion) spending package for the next seven years, including a €750 billion recovery fund which will be raised on the capital markets by the EU itself, not by individual countries.

INFLATION

A recent research paper by the FED shows that “zombie credit”—cheap credit to impaired firms—has a disinflationary effect. By helping distressed firms to stay afloat, such credit creates excess production capacity, thereby putting downward pressure on product prices. Granular European data on inflation, firms, and banks confirm this mechanism. Industry-country pairs affected by a rise of zombie credit show lower firm entry and exit rates, mark-ups, and product prices, as well as a misallocation of capital and labour, which results in lower productivity, investment, and value-added. Without a rise in zombie credit, inflation in Europe would have been 0.4% higher post-2012.

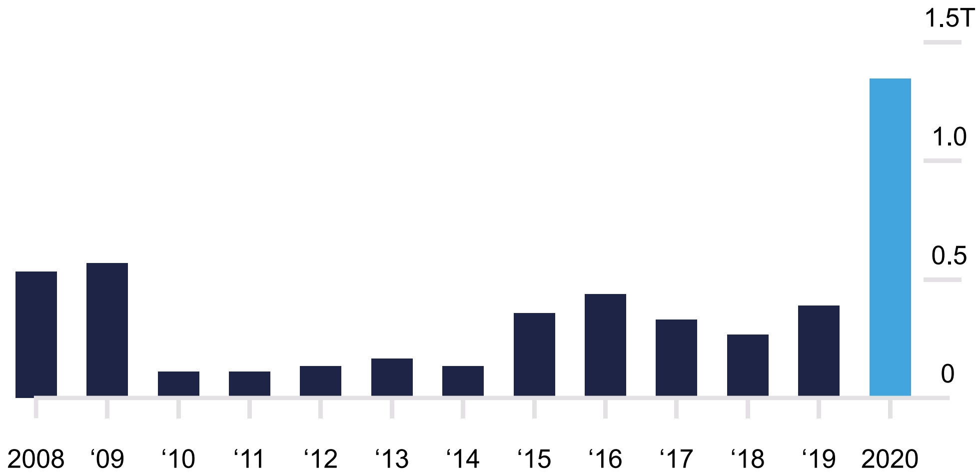
- Inflation: Euro Area

PIIGS HICP YoY



Undead Debt

Zombie firms are sitting on an unprecedented $1.4 trillion of obligations



Source: Bloomberg
Note: 2020 figures as of most recent quarterly data.

[“Zombies” are firms whose debt servicing costs are higher than their profits but are kept alive by relentless borrowing. Such is a macroeconomic problem. Zombie firms are less productive, and their existence lowers investment in, and employment at, more productive firms. In short, a side effect of central banks keeping rates low for a long time is it keeps unproductive firms alive. Ultimately, that lowers the long-run growth rate of the economy.”]

GLOBAL DEBT

Impact of the COVID-19 pandemic: To tackle the health crisis caused by the COVID-19 pandemic and its massive impact on economies and financial markets, Governments and Central Banks of the Organisation for Economic Co-operation and Development (OECD) countries have deployed a wide range of measures since March 2020. In addition to large discretionary fiscal stimulus packages, automatic fiscal stabilisers have also led to sudden and significant increases in cash requirements. As a result, sovereign borrowing needs have surged in many countries.

The total market borrowing in 2020 reached an unprecedented level of USD 28.8 trillion in bonds and bills. With interest rates at record lows in most OECD countries, **the primary challenge for many sovereign issuers is to increase debt issuance significantly without undermining the functioning of sovereign bond markets.**

With public debt soaring across the world, a growing concern is whether current debt levels are a harbinger of fiscal crises, thereby restricting the policy space in a downturn.

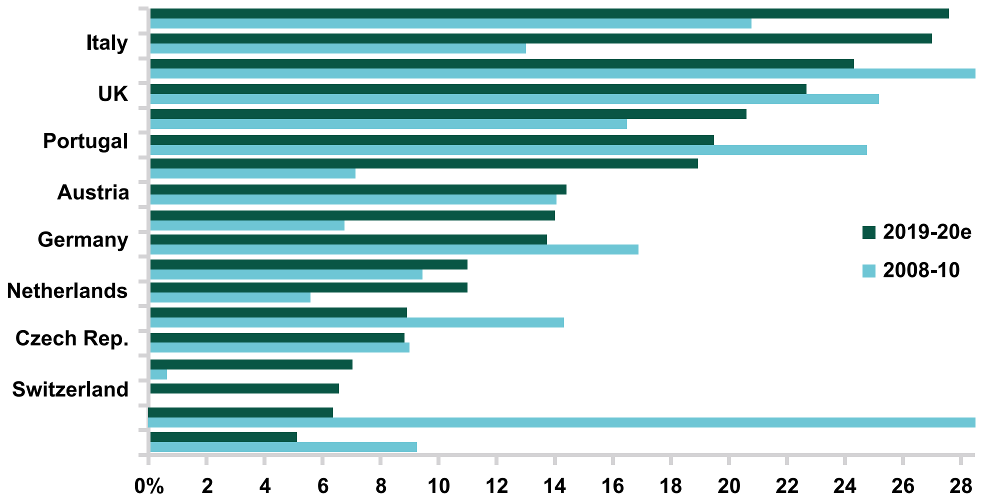
GLOBAL DEBT SOARED TO A NEW RECORD HIGH OF $281 TRILLION IN 2020

Coupled with a sharp pandemic-driven decline in government and corporate revenues, total private and public debt rose by $24 trillion last year, making up over a quarter of the $88 trillion rise over the past decade (chart below). Debt outside the financial sector hit $214 trillion, up from $194 trillion in 2019.

Source: IIF, BIS, IMF, National sources

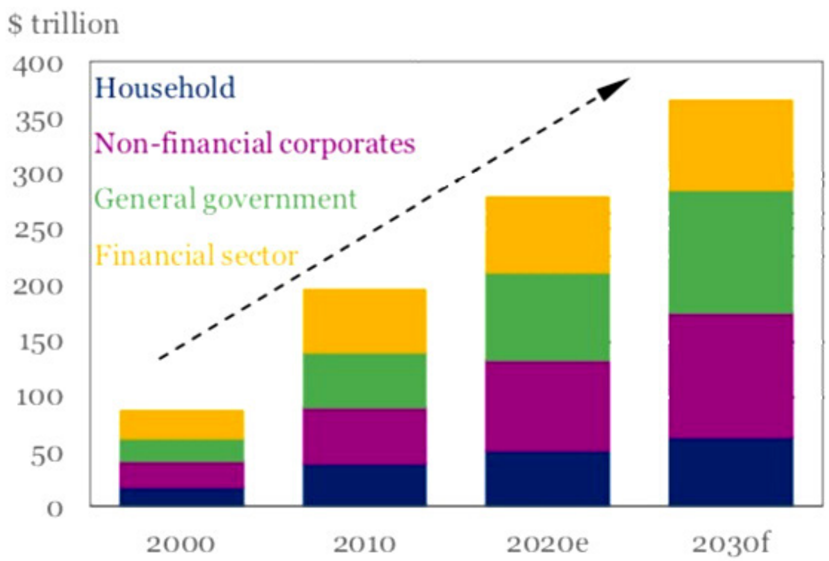
In the **Euro Area**, a $1.5 trillion rise in government debt pushed total debt over $53 trillion in Q3/2020 (though this is still below the all-time high of $55 trillion in Q2/2014). Debt in other mature markets rose by over $3.7 trillion to $65 trillion in the first three quarters of 2020.

Change in debt-to-GDP ratio (EU members), in %



Source: IMF, BNP Paribas Asset Management, as of 11/11/220

While some $15 trillion of this surge has been recorded in 2020 amid the COVID-19 pandemic, the debt build-up over the past four years has far outstripped the $6 trillion rise over the previous four years and over earlier comparable periods. As a result, there is significant uncertainty about how the global economy can deleverage in the future without significant adverse implications for economic activity. The next decade could bring a reflationary fiscal response, in sharp contrast to the austerity bias in the 2010s. If the global debt pile continues to grow at the average pace of the last 15 years, our back-of-the-envelope estimates suggest that **global debt could exceed $360 trillion by 2030** (chart below) — over $85 trillion higher than current levels. (by IIF)



Source: IIF, BIS, IMF, National sources

Global Banks in a time of crisis: Delinquencies and defaults are set to rise, while leverage has crept higher and covenants have been loosened. Many borrowers have drawn their revolving credit facilities ("RCFs"), meaning that banks now have larger exposures. There has also been a correlation of stress across sectors and borrowers, which affects the ability of banks to manage losses. Forbearance will be required, and policymakers have responded quickly with packages that aim to address short-term liquidity issues. With interest rates at record lows, governments have turned to fiscal measures and are using banks as the transmission mechanism for stimulus. Despite the hazards involved, banks will underwrite losses in the system. In turn, these losses should be mitigated by government guarantees. While European banks are still paying coupons on debt instruments, their decision to suspend dividends will help protect capital if support is needed. However, the rising strains on the economy could lead to a tightening in bank lending, which would particularly affect speculative-grade companies with weak liquidity that have drawn on their banking facilities. This could lead to a more pronounced increase in defaults.

Fundamentals remain rock solid, a rise in non-performing loans (NPLs) is manageable: From a credit perspective, European banks have outperformed expectations and are entering 2021 in a position of strength. Capital has been the big beat, with an aggregate common equity tier one ("CET1") ratio of 15.0% at the end of the first half of 2020, near all-time highs. Coverage ratios are well over 130% in Europe, meaning that funding gaps have fallen. Since the coronavirus crisis erupted, new government schemes have injected liquidity into the market, while there are measures in place to support commercial paper and repurchase-agreement markets. Excess capital has increased significantly, now standing well above EUR 500 billion for the sector. Asset quality trends have also surprised to the upside, with NPLs only modestly rising by 20 bps to 2.9% year-to-date. While cost of risk has been elevated, pre-provision profits have been more than sufficient to absorb loan loss provisions ("LLPs"). The ECB is tolerating slower non-performing exposure targets and delayed recognition of NPLs. Banks have lost about a third of their market capitalisation since the sell-off and their debt instruments have experienced some of the greatest losses of any sector. Regulators and banks have reduced this risk over the last decade, and there are currently few signs of stress. During the last financial crisis, liquidity issues and a mismatch between assets and liabilities were the final straw.

NPLs are expected to rise during the second half of 2021 as government measures aimed at providing liquidity to corporates (government guaranteed loans) and replacing income for individuals ease off. Despite a potential future rise in NPLs, we do not see this as a material risk for bondholders – especially with new accounting rules in place (IFRS9) forcing banks to take a forward-looking approach toward LLPs – i.e. making provisions based on macroeconomic assumptions even before NPLs arise. This means that a rise in future NPLs is already accounted for in 2020 LLPs set aside by banks. This is reflected in bank outlooks for LLPs, which are expected to decline significantly in 2021 compared to 2020 levels. As an example, HSBC Bank has guided to the lower end of its USD 8/13 billion guidance for 2020, while consensus estimates for 2021 suggest USD 5 billion, close to half. Moreover, even an unexpected surge in NPLs would be mitigated by various lines of defense and bondholders are well protected.

PRIVATE DEBT

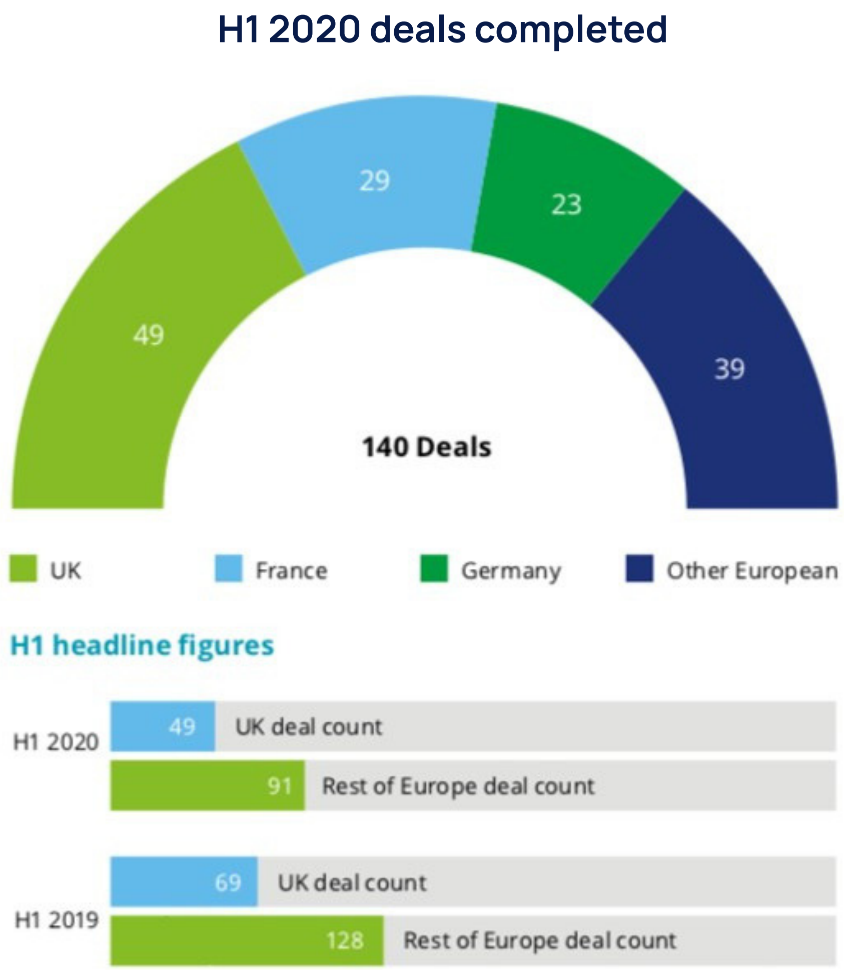
The private credit industry emerged in the aftermath of the last global financial crisis ("GFC") and has grown strongly ever since, both in terms of capital raised and the strategies in which it is employed. It is logical to ask questions about the future of private credit in the context of the COVID-19 pandemic, both in terms of the immediate and longer-term effects.

Private finance is playing an increasing role in financing the economy. The Covid-19 crisis has and will have a direct impact on this sector, this is a trend that will be increasing during the recovery period post-Covid, particularly on refinancing the debt of certain target companies and certain funds, and even on the solvency of some of them.

As private markets in Europe continue to add flexibility, depth, and sophistication, investors that are already allocating to private debt have unsurprisingly built larger and more complex portfolios over time as they have become more confident about the long-term viability of the asset class. Investors that have not yet allocated capital to private debt recognise how the asset class can help them meet their long-term objectives, with many showing a greater understanding and appreciation for the range of opportunities within the asset class.

NON-PERFORMING LOAN TRANSACTIONS IN EUROPE

At the end of 2020, a total of 140 NPL deals occurred, UK with 49, France with 29, Germany with 23, and the rest of the EU with 39. The hunt for yield with strong technical values will continue further into 2021, with long-term low-interest rates, Covid-related disruptions, and the attendant need for finance among borrowers likely to continue beyond 2021.



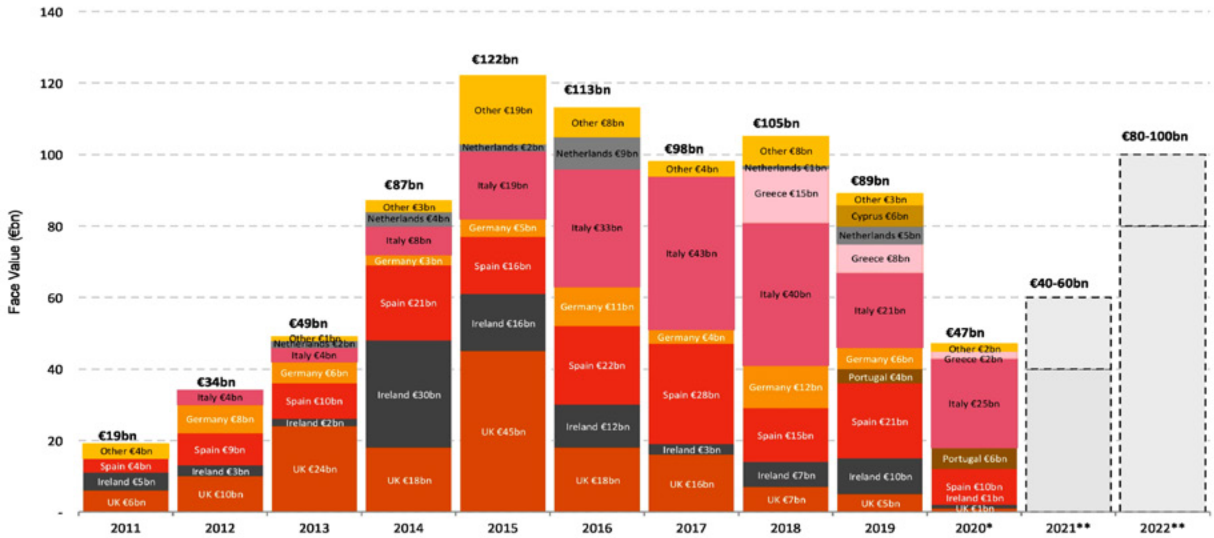
It is too early to say where NPL levels will peak following the pandemic - according to the ECB, Banks are "all over the place" on provisioning for the likely rise in NPLs, noting that this is a concern to supervisors.

The ECB has also expressed concerns that NPLs will clog up banking balance sheets which will reduce their ability to support recovery. This call to action will lead to a continuing reassessment of banking balance sheets and trading not just of NPL portfolios, but there will also be investment opportunities for buyers of performing assets and non-core businesses.

On NPL trades, looking forward, **PWC estimates that NPLs 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. During 2021 PWC expects much of this trading to be of legacy stock whilst thereafter likely to be newer stock arising from the current crisis.**

It is interesting to compare provisioning levels around Europe. It appears that banks in Spain and the UK are taking greater provisions. Much like after the 2008 financial crisis we, therefore, expect banks in northern Europe and Spain to lead the way, but unlike the financial crisis, we expect a greater emphasis on SME lending rather than consumer debt. Transaction volumes will increase - and there will be a continuous activity for quite some time.

NPL traded volumes €bn 2011 to 2022



2020* represents estimated volumes for 2020
2021* and 2022 represent forecast volumes for 2021 and 2022 based on PwC Internal analysis

WRU WIMMER RESEARCH UNIT

Reported to date (€bn)	# Banks reported	EBA Banks	NPL Volumes			QoQ Provision			9M Provision	NPL Ratio			Gross Loans		
			Jun-20	Sep-20	% change	Jun-20	Sep-20	% change	Sep-20	Jun-20	Sep-20	% change	Jun-20	Sep-20	% change
France	4	9	95.3	89.3	-6%	4.9	2.9	-40%	11.5	2.9%	2.6%	-10%	3,250	3,194	-2%
Germany	6	16	19.7	19.6	-1%	1.3	0.7	-44%	3.0	1.9%	1.5%	-21%	1,023	1,014	-1%
Ireland	1	3	3.7	4.0	7%	1.0	-	-100%	-	6.2%	6.1%	-2%	60	60	-1%
Italy	9	11	92.7	89.0	-4%	3.4	12.9	281%	8.6	6.8%	6.7%	-1%	1,365	1,359	0%
Netherlands	2	6	21.2	21.2	0%	2.0	0.7	-64%	4.6	2.0%	2.2%	10%	1,048	1,016	-3%
Portugal	2	5	4.7	4.3	-8%	0.2	0.2	-19%	0.5	4.4%	4.4%	0%	107	107	0%
Spain	11	12	78.3	75.7	-3%	7.0	4.6	-34%	19.6	3.6%	3.6%	0%	2,158	2,107	-2%
Sweden	5	6	3.7	3.7	-1%	0.4	0.2	-61%	1.0	0.6%	0.6%	0%	617	614	0%
UK	5	6	50.8	50.9	0%	10.6	2.3	-79%	20.9	2.0%	2.0%	0%	2,538	2,500	-1%
Remaining EU/EEA	30	54	68.4	59.0	-14%	5.1	2.0	-61%	11.1	3.1%	2.1%	-32%	2,206	2,189	-1%
	79	128	438.5	416.7	-5%	36.0	26.5	-26%	80.8	3.4%	3.3%	-3%	14,372	14,160	-1%

In an adverse scenario, the ECB has estimated that the amount of non-performing loans (NPLs) in the Euro area might reach €1.4 trillion by the end of 2022, while the Eurozone NPL ratio is expected to increase from 3.1% in Q4 2019 to 4.7% - 5.4% by the end of 2021. This would put between €255-380 billion of additional NPLs on Eurozone banks' balance sheets by the end of 2021.

IN JUNE 2020, THE FOLLOWING STATISTICS WERE RECORDED:

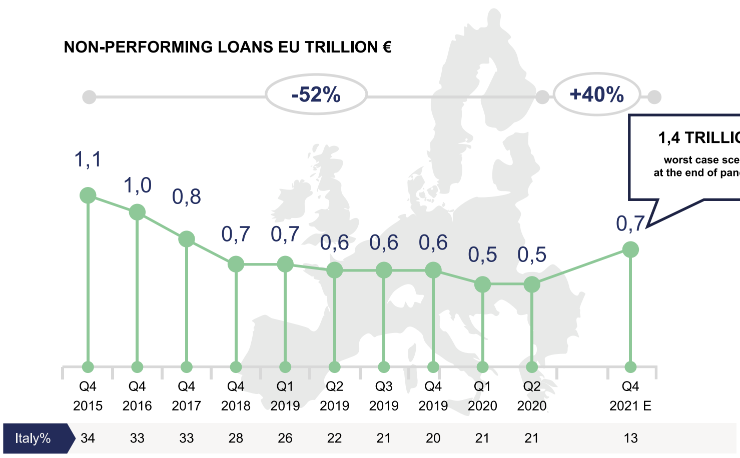
- The total NPL volume stood at €528 billion, 10% less than 1 year earlier (€581 billion). Following a multi-year period of decreasing NPL volumes, the volume of NPLs increased for the first time, albeit marginally, during the second quarter of 2020 (€4 billion increase).

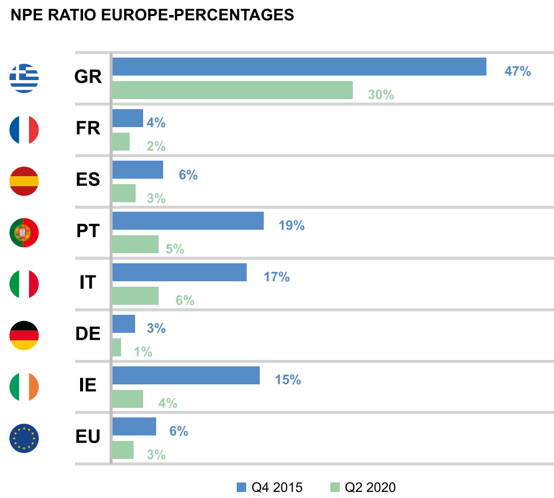
- Non-Financial Corporations (NFC) and household NPLs made up more than 95% of total NPLs and reached EUR 510 billion. The rest of the NPLs reported by EU banks were to sovereigns and financial institutions (around EUR 19 billion). NPL ratios vary significantly across segments, which also reflects the riskiness of the exposures.

- The EU NPL ratio for NFC loans stood at 5.1%, around 90 bps down from the previous year. The decrease in NPL ratios was more evident for the CRE (7.3% in June 2020 versus 8.9% in June 2019) and the SME (7.2% versus 8.7%) segments. EU banks also reported a decrease in the NPL ratio for households (YoY), although this was smaller than that for NFCs.

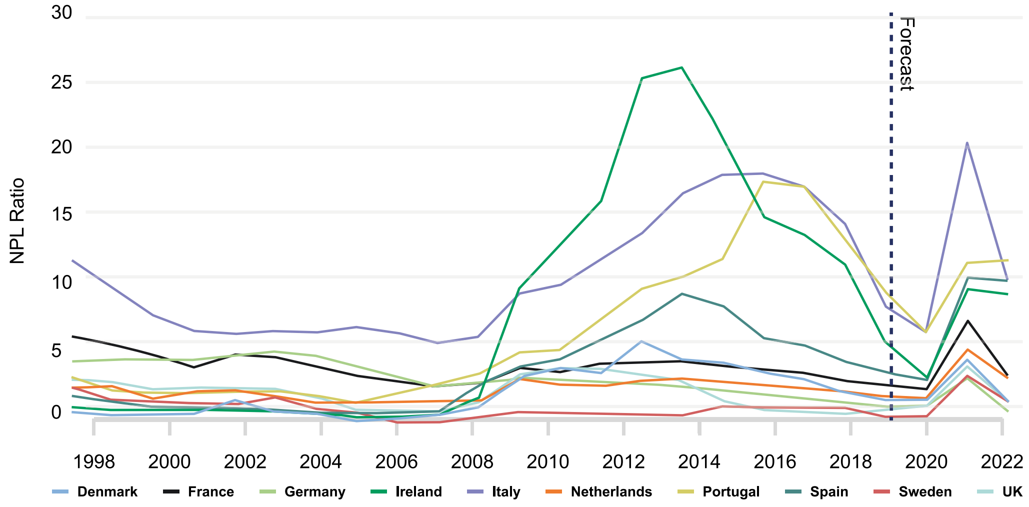
- The NPL ratio of the household segment stood at 3.3%, 30 bps lower than in June 2019, which was flat compared with March 2020. EU coverage ratio of NPLs stood at 45.5%, marginally lower than a year earlier (46.1%) in Q3/2020.

It is a fact that the two-year period 2021-2022 will see an increase in nonperforming loans. The deterioration in asset quality amid rising insolvencies would surely push banks to tighten credit conditions in 2021 in Italy, Portugal, Spain, and France as well has put bank profitability under pressure in Germany, Belgium, and Portugal.





It is expected that there will be a material increase in NPLs in 2021, especially in France, Italy, the UK and Spain. Ireland, Spain and Portugal will stay well below their peaks of the last crisis, whereas those former peaks will be reached or exceeded in Italy, France and the UK. (Chart)



Historical data of the NPL ratio for selected countries in Europe and forecasts for 2020 and 2022 based on a pooled panel regression model (Model with pooled macro sensitivities using all country data)

Given the uncertainty in the further development of the pandemic, forecasts for NPL will remain highly uncertain. Nevertheless, a few conclusions are fairly robust: while the pandemic is a truly global phenomenon, different countries and economic sectors are impacted to a varying degree. It is also clear that the wave of new NPL will vary by asset class and economic sector with SME loans and commercial real estate loans looking more vulnerable than residential mortgages and large corporate loans. Countries in Southern Europe with their larger share of economic activity in badly hit sectors like tourism and hotels will likely suffer more than countries in Northern Europe.

NPL LOSS SIMULATIONS (2019-2021):

	Dec 2019		Dec 2021			
	NPL ratio (%)	NPL amount (bl EUR)	NPL ratio (%)		NPL amount (bl EUR)	
			LOWER	UPPER	LOWER	UPPER
France	2.5	117.21	4.5	5.4	209.30	255.35
Germany	1.3	29.98	2.0	2.3	45.04	52.56
Italy	6.7	115.53	13.9	17.4	239.10	300.88
Spain	3.2	79.15	6.6	8.2	162.07	203.53
UK	1.3	53.59	3.3	4.3	135.45	176.38
Belgium	1.8	8.41	3.6	4.5	16.66	176.38
Netherlands	1.6	34.21	2.4	2.9	52.13	61.09
Portugal	7.6	12.74	14.1	17.3	23.58	29.00
euro zone	3.1	507.43	4.7	5.4	762.15	889.51
NPL change 2019-2021			**1.6**	**2.3**	**254.72**	**382.08**

Sources: Allianz Research,, European Banking Authority

TECHNOLOGY AS A VALUE DRIVER IN NPL MANAGEMENT

As we look back on 2020, we see that the world has had an opportunity to "test drive" the future - and it looks bright with digitisation, analytics, artificial intelligence, and automation being unstoppable trends.

The ECB identified that only 21 of 113 significant institutions were able to forecast the level their NPLs will have reached by the end of 2021. The speed of change will be significant and it seems that for most lenders recognising the levels of impairment, predicting future NPL levels, and spotting significant changes in their portfolios is a true challenge.

A surge of demand for new loans is also expected in the wake of Covid, but banks with large stocks of impaired assets will struggle to grow their business because their liquidity ratios will be poor and they won't be allowed to lend as much as they otherwise could.

Under the conditions, collection operations are expecting more automation, ease-of-use, efficiency, compliance, control, flexibility, and manageability from their collection system. Moreover, the COVID-19 has posed various challenges for financial institutions to reach out to their debtors. FinTech companies are offering a helping hand to provide creditors and collections functions with sophisticated software for debt collection automation and debt collection management. A combination of their efforts is making it possible for organisations to strengthen their debt recovery strategies by focusing on saving time, cost reduction, and maximizing resources. Furthermore, digital self-service portals and omnichannel communications are helping to increase the payments and reduce the costs for call centers, while strengthening customer satisfaction.

In parallel, every financial institution and credit management entity must make its data and insights work harder. This means that businesses must act now to utilise data, understand customer behavior and circumstances and translate these into clear, identifiable steps, to sustain them through a period of unpredictability and potentially severe disruption. They must focus on innovation. Now is the time when banks, credit unions, and collections organisations that have invested in advanced analytics and digital transformation can benefit from the full potential of their customer experience.

EUROPE: LATEST REGULATORY POLICY MEASURES:

The NPL securitisation regulatory landscape is fast changing. In the last year alone, the EBA, Basel, and the European Commission have all proposed significant amendments to the current regulatory capital treatment of NPL securitisations. Further, the current securitisation framework is scheduled to be reviewed in-depth in January 2022.

On 2020 December 16th the European Commission with the Coronavirus response issued the guideline: "Tackling non-performing loans (NPLs) to enable banks to support EU households and businesses". The European Commission presented a strategy to prevent a future build-up of nonperforming loans (NPLs) across the European Union as a result of the coronavirus crisis. The strategy aims to ensure that EU households and businesses continue to have access to the funding they need throughout the crisis. Banks have a crucial role to play in mitigating the effects of the coronavirus crisis, by maintaining the financing of the economy. This is key in order to support the EU's economic recovery. Given the impact coronavirus has had on the EU's economy, the volume of NPLs is expected to rise across the EU, although the timing and magnitude of this increase are still uncertain. Depending on how quickly the EU's economy recovers from the coronavirus crisis, banks' asset quality – and in turn, their lending capacity – could deteriorate.

Valdis Dombrovskis, Executive Vice-President for an "Economy that Works for People", said: "History shows us that it is best to tackle non-performing loans early and decisively, especially if we want banks to continue supporting businesses and households. We are taking preventive and coordinated action now. Today's strategy will help contribute to Europe's swift and sustainable recovery by helping banks to offload these loans from their balance sheets and keep credit flowing."

Mairead McGuinness, Commissioner responsible for financial services, financial stability, and the Capital Markets Union, said: "Many firms and households have come under significant financial pressure due to the pandemic. Making sure that European citizens and businesses continue to receive support from their banks is a top priority for the Commission. Today we put forward a set of measures that, while ensuring borrower protection, can help prevent a rise in NPLs similar to the one after the last financial crisis."

In order to give Member States and the financial sector the necessary tools to address a rise of NPLs in the EU's banking sector early on, the Commission is proposing a series of actions with four main goals:

1. **Further developing secondary markets for distressed assets:** This will allow banks to move NPLs off their balance sheets while ensuring further strengthened protection for debtors. A key step in this process would be the adoption of the Commission's proposal on credit servicers and credit purchasers which is currently being discussed by the European Parliament and the Council. These rules would reinforce debtor protection on secondary markets. The Commission sees merit in the establishment of a central electronic data hub at an EU level to enhance market transparency. Such a hub would act as a data repository underpinning the NPL market in order to allow a better exchange of information between all actors involved (credit sellers, credit purchasers, credit servicers, asset management companies (AMCs), and private NPL platforms) so that NPLs are dealt with effectively. On the basis of a public consultation, the Commission would explore several alternatives for establishing a data hub at the European level and determine the best way forward. One of the options could be to establish the data hub by extending the remit of the existing European DataWarehouse (ED).

2. **Reform the EU's corporate insolvency and debt recovery legislation:** This will help converge the various insolvency frameworks across the EU, while maintaining high standards of consumer protection. More convergent insolvency procedures would increase legal certainty and speed up the recovery of value for the benefit of both the creditor and the debtor. The Commission urges the Parliament and Council to reach an agreement swiftly on the legislative proposal for minimum harmonisation rules on accelerated extrajudicial collateral enforcement, which the Commission proposed in 2018.

3. **Support the establishment and cooperation of national asset management companies (AMCs) at EU level:** Asset management companies are vehicles that provide relief to banks that are struggling by enabling them to remove NPLs from their balance sheets. This helps banks refocus on lending to viable firms and households instead of managing NPLs. The Commission stands ready to support the Member States in setting up national AMCs – if they wish to do so – and would explore how cooperation could be fostered by establishing an EU network of national AMCs. While national AMCs are valuable because they benefit from domestic expertise, an EU network of national AMCs could enable national entities to exchange best practices, enforce data and transparency standards, and better coordinate actions. The network of AMCs could furthermore use the data hub to coordinate and cooperate in order to share information on investors, debtors, and servicers. Accessing information on NPL markets will require that all relevant data protection rules regarding debtors are respected.

4. **Precautionary measures:** While the EU's banking sector is overall in a much sounder position than after the financial crisis, Member States continue to have to vary economic policy responses. Given the special circumstances of the current health crisis, authorities can implement precautionary public support measures, where needed, to ensure the continued funding of the real economy under the EU's Bank Recovery and Resolution Directive and State aid frameworks.

OUTLOOK 2021 AND BEYOND

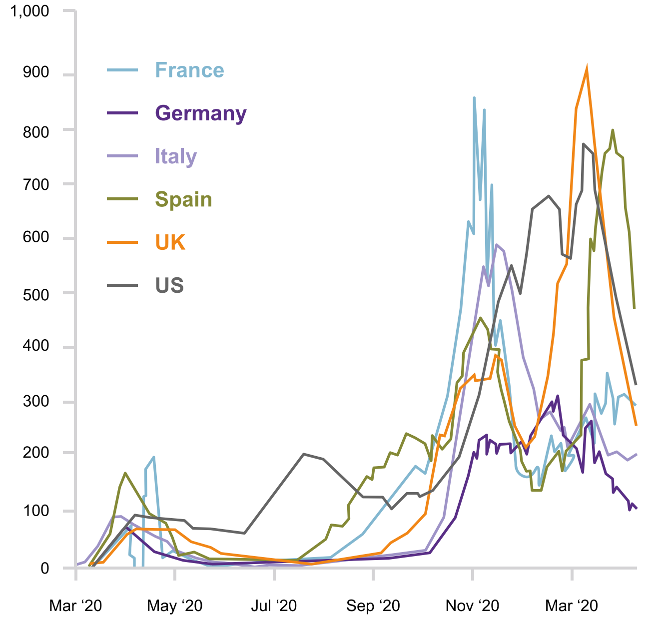
The Covid-19 vaccine will supercharge global growth in 2021, but short-term headwinds, and a complete recovery only by 2022, will create transition risks. Following the sharp Q3 rebound in economic activity, the roller-coaster ride continues at the turn of 2020/21. The resurgence of Covid-19 cases and fresh lockdowns will bring global economic activity to a stand-still, with the quarterly rate slowing to +0.1% [Q/Q] in Q4 after +7.3% [Q/Q] % in Q3.

The double-dip in Europe and a marked slowdown in the US mean things will get worse before they get better. Amid exceptional uncertainty, the global economy is projected to grow 5.5 percent in 2021 and 4.2 percent in 2022. The 2021 forecast is revised up 0.3 percentage point relative to the previous forecast, reflecting expectations of a vaccine-powered strengthening of activity later in the year and additional policy support in a few large economies (IMF).

2023 may be a reality check as countries shall return close to potential growth, revealing who seized or wasted the crisis.

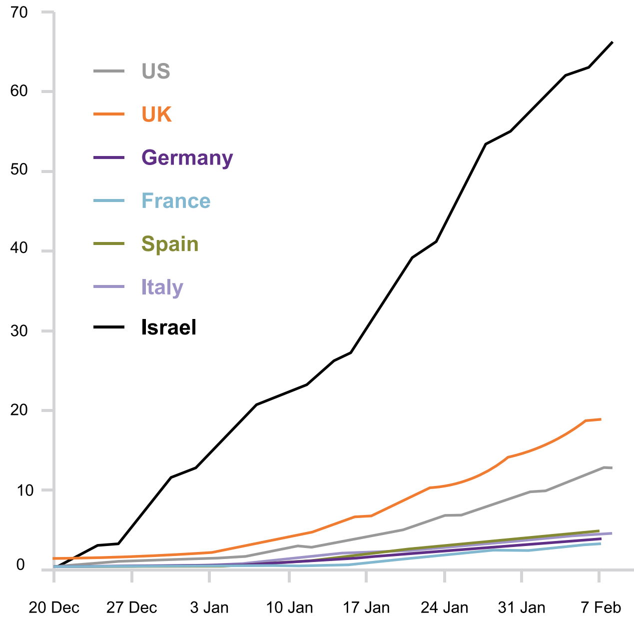
Daily increase in Covid-19 cases

Seven-day moving average, per million people



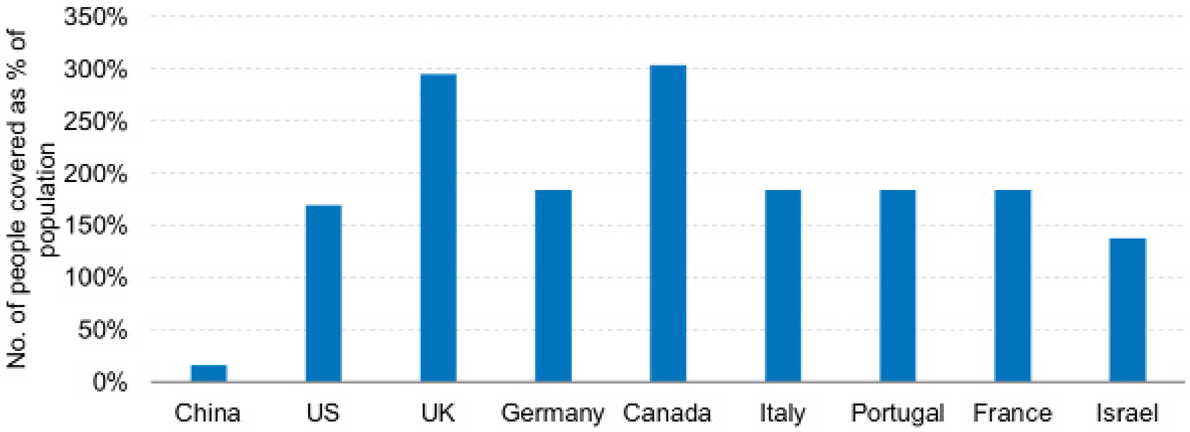
Covid-19 vaccine rollout

Cumulative doses administered per 100 people



Vaccines ordered

Coverage across countries varies



Source: BMO Global Asset Management and Bloomberg as at 7 January 2021

UNITED KINGDOM (UK)

The U.K.'s December inflation rate accelerated to 0.6% y/y in December from 0.3% in November but remained meager compared with where it was before the pandemic. The headline was supported by a strong rise in prices of transportation and recreation and culture, while food and energy prices weighed on the overall number. Core inflation accelerated, mainly because of a softer drop in prices of clothing and footwear and stronger gains in furniture prices. The December gain was likely short-lived, though. In the UK, Brexit will act as a drag on the post-lockdown recovery, with GDP to remain -5% below pre-crisis levels at end-2022/23. The U.K.'s three-month moving average unemployment rate has increased to 5.1% during December. As a new variant of the COVID-19 virus spread and Brexit uncertainties mounted, the British economy was in a rough spot at the end of 2020. Although the EU and U.K. signed a light trade deal at the last minute, the possibilities that the UK will enter a technical recession in the first quarter are likely. The trade deal contained little clarity on financial services. Although the UK was the first country to start vaccinations and is the fastest in Europe in terms of the speed of vaccinations, this will provide little relief over the next couple of months.

The UK continues to be the major source, for deal volume, of direct lending in Europe, and this is a trend that is going forward since 2012. Despite the Covid environment, non-bank lenders still have significant capital deployment targets. Lenders have been actively promoting special situation strategies, which are likely to be applicable as the impact of Covid ripples through the economy. Even in the most resilient sectors, non-bank lenders reflected additional Covid related risk by reducing leverage levels by up to 2x EBITDA and increasing pricing by up to 300bps. In Q2 there were initially 40 accredited lenders in the UK. To support their borrowers, other lenders including OakNorth and ThinCats became accredited to provide CBILS funding.

The number of UK banking deals (excluding super senior) decreased from 99 in H1 2019 to 42 in H1 2020. The most active term bank lenders in H1 2020 were NatWest (nine participations), Lloyds (eight) and HSBC (seven). The banks completed deals in sectors ranging from TMT to Education in Q1 2020 but, for H1 2020, combined activity for the three lenders was 57% lower than H1 2019. Over 83% of the activity in H1 2020 occurred in the first quarter, with only seven deals completed in Q2.

In September 2020, UK reported a volume of NPLs (EUR 50,9 Bn) while in June (50,8Bn), with an NPL ratio of 2%. Banks have been busy supporting existing clients in Q4 2020 who have suffered during the Covid pandemic. Numerous covenant breaches have been waived and, overall, banks have engaged constructively with sponsors and borrowers to agree to a road to recovery.

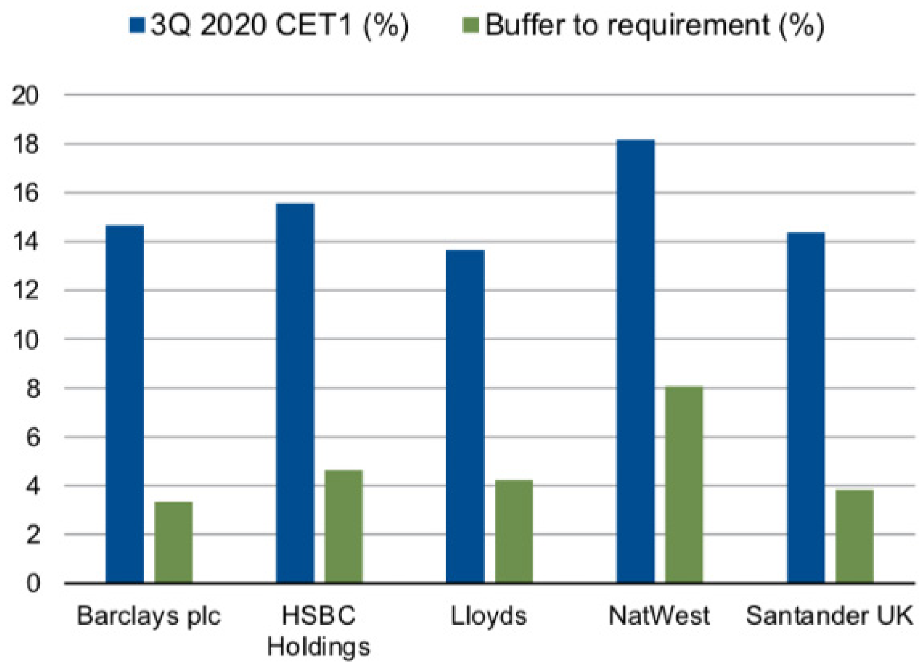
Since October, more than 850,000 CBILS/ CLBILS applications have been processed by accredited lenders. Some sponsors have complained that it is challenging to gain additional liquidity through these processes, which is demonstrated by only 50% of applications being successful.

The £1.5 trillion domestic residential mortgage market comfortably represents the largest component of U.K. banks' loan books. Following a collapse in second-quarter 2020, there is evidence of a strong rebound in mortgage approvals, housing transactions, house prices, and mortgage spreads, in part aided by a temporary relaxation in stamp duty. If these trends continue, they could help bank revenue more than we assume and lead to mortgage provision releases.

The pace of regulatory activity should remain high as the UK considers how best to utilise the flexibility afforded by no longer being bound by EU rules. In March 2020, the UK government published its approach for updating the prudential regime for banks to enable the implementation of finalised Basel III reforms (Basel 3.1) agreed in December 2017. These still need to be implemented as few of these revisions are included in CRR II and CRD V. The UK has stated that it remains committed to the full, timely, and consistent implementation of Basel 3.1 standards in line with the new deadline of January 2023.

In January 2021, the Bank of England disclosed further details on this year's regular annual stress test to be performed on end-2020 balance sheets. In addition to the usual seven large banks and building societies, Virgin Money UK (now incorporating Clydesdale Bank and Yorkshire Bank) will be included for the first time. Each Bank's capital low point will be benchmarked against a reference point equal to its minimum CET1 requirement (sum of 4.5% Pillar 1 minimum, Pillar 2°, and any systemic buffers). The results will be published in Q4 2021.

CET1 capital position and buffer to requirements



Note: CET1 figures on transitional basis.

FRANCE

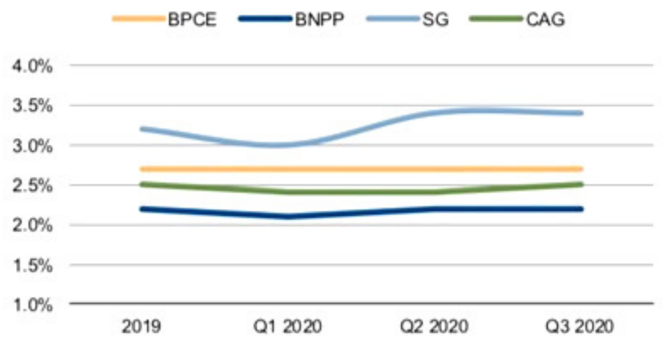
After a contraction of -9.9% in 2020, we expect a rebound in French GDP of +6.1% in 2021, followed by above-potential growth in 2022 (+3.8%). Consumer spending will remain the key driver of the recovery, thanks to improved confidence and the un-leashing of EUR19Bn of excess savings. In France, the number of job seekers rose in December by roughly 30,000 to 3.61 million. However, the continuation of the country's short-time work scheme will keep a lid on the unemployment rate for now. The unemployment rate is expected to rise to 9.9% in 2021 and 10.1% in 2022. The sharp increase in public debt, linked to the necessary extension of support measures, could ultimately reduce budgetary room for a makeover, particularly in the event of persistently weak growth.

The French Economic Observatory (OFCE, Observatoire Français des Conjonctures Economiques) has estimated the default rate at 3.2% at the end of 2020 (compared with 1.8% without the pandemic), with a higher proportion in certain sectors, such as hotels and restaurants (12%) or household services (9%). Credit quality has shown a marked deterioration since the crisis. These risks call for rapid action on the part of the financial ecosystem, which must, in particular, be based on the development of harmonized risk measurement capacities, based on the standardization of extra-financial data, and the conduct of stress tests. Structural reforms, fiscal stimulus, accommodative monetary policy, and the government's EUR 100bn longer-term investment program - "France Relance" (4% GDP)- will support the recovery.

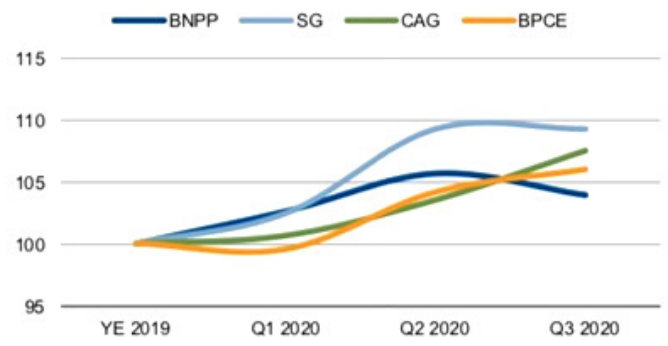
In September 2020, France reported the highest volume of NPLs (EUR 89.3 billion), which was slightly up from the previous year. Reported Non-Performing Loan (NPL) ratios have remained flat since the beginning of the year (Figure Below), in the 2.2%-3.3% range – low to average by European standards. This stability should be seen in the context of dynamic loan production, boosted by the government-backed lending program. The rise of problem loans is modest in volume and controlled (Figure below). The stock of NPLs at the start of the crisis was also at a low in the current credit cycle.

France NPL / Banking loan ratios (Scope Rating Agency)

Reported impaired loans ratio (%)



Reported impaired loans outstanding, 100 = end 2019

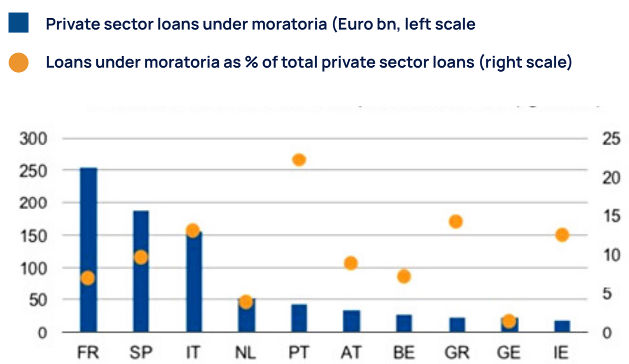


Granting EUR 255bn of moratoriums helped overcome the first lockdown: French banks have been among the largest providers of loan moratoriums by volume in Europe. This is noticeable in the absence of State-directed measures in the form of legislative schemes. According to EBA data, French banks granted EUR 255bn of moratoriums as of June 2020, representing 7.1% of loans to the private sector (households and non-financial corporations). By category of borrowers, loans under moratorium accounted for 3.3% of mortgage loans, 12.6% of loans to non-financial corporations (21.2% for SMEs).

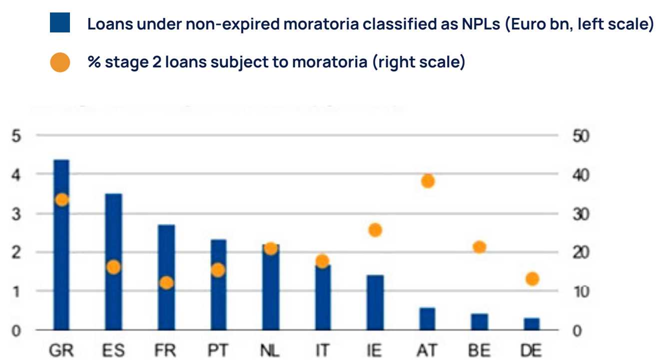
The reported amount of Non-Performing Loans to loans under moratorium was also small, just above 1%. As of June, about 60% of moratoriums were due to expire within three months, less than 3% after nine months. **Maintaining support initiatives until the economic recovery kicks-in is critical to prevent a surge of problem loans onto bank' balance sheets.**

On November 25th, the European Central Bank warned that "a premature end of government guarantees and moratoria could lead to an additional wave of losses". The aim of this phasing out was to help transition back to pre-crisis practices. However, the second lockdown has renewed pressure on some borrowers. It remains to be seen how the most fragile clients will be able to continue benefiting from this flexibility.

Volumes and percentage of loans under moratorium in selected European countries as of June 2020



Overview of asset-quality indicators for loans under moratorium in selected European countries as of June 2020



GERMANY

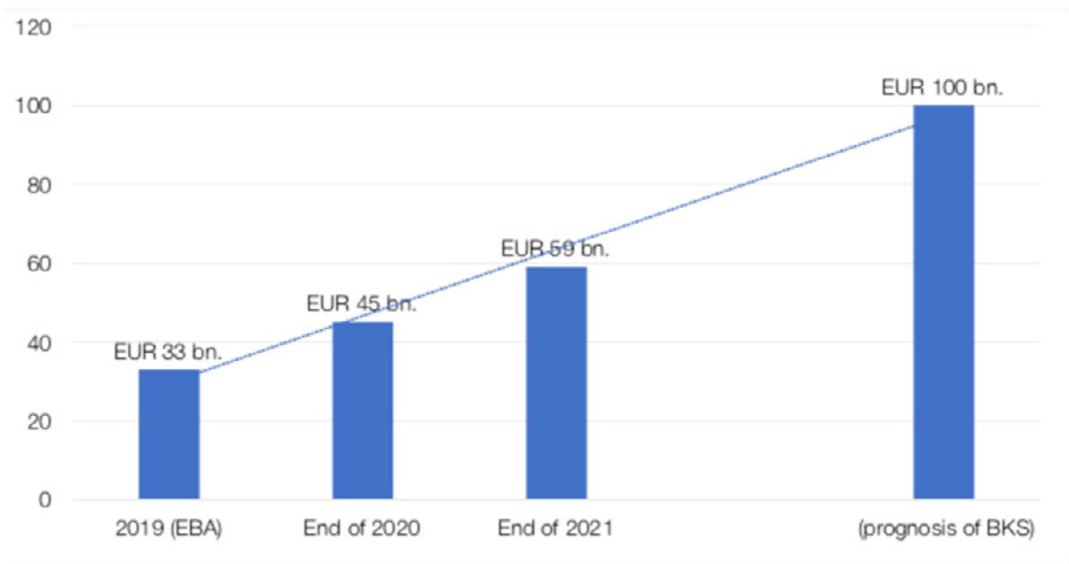
Over the year, the German economy will move at a rapid pace through the entire economic cycle palette, from short-term economic gloom in Q1 to a vaccine-driven consumption boom in the second half of the year. The German unemployment rate was likely unchanged at 6.1% in December, though we expect upward pressure to build as the country imposed harsher lockdown measures in mid-December and since extended them to February.

The corporate sector is suffering considerably and many firms will not survive a collapse in demand, also due to change in business models. Total debt amounts to only 61% of GDP, compared to 109% in the Eurozone, and 78% both in the US and the UK.

German corporate debt has risen only gradually in recent years, in line with a pickup in loan growth which has outpaced nominal GDP growth since 2018. Demand for loans to enterprises remains robust, supported by debt refinancing and restructuring. A decline in short-term loans indicates lower emergency needs. However, German banks benefit from better asset quality (NPL ratio of 1.7%) than other European banks (8.1%), and price contractions have been less pronounced during recessions, compared with the European average.

While the European Banking Authority (EBA) put the total of NPL inventories of German banks at EUR 33 Bn in 2019, the market players expected an average increase up to EUR 45 Bn by the end of 2020 and to EUR 59 Bn by the end of 2021 (by University of Frankfurt' chart below).

"We continue to expect the absolute figures to triple to more than 100Bn Euros in the next three years," says Jürgen Sonder, President of the Federal Association of Loan Purchase and Servicing (Bundesvereinigung Kreditankauf und Servicing).› Risk perceptions are the main factor contributing to the tightening of credit standards. The market players expect in 2021 an increase in NPL inventories, numbers of sales of receivables, declining transaction prices, and a stronger focus on portfolio outsourcing–all in all, a more active market for trading in non-performing loans. **The pandemic has accelerated disruption risk from fintech and big tech players. Many German banks need to improve their core IT systems. Larger groups need to further optimize costly branch networks, improve cost-to-income ratios to better withstand the economic crisis, and transform operating models.** The lockdowns in response to COVID-19 are catalyzing customers' adoption of digital banking and speeding up digitalization.



Expected NPL volumes in German banks for the years 2020 and 2021 (average of all answers)

What's more, industry players expect a rush of Non-Performing Loans currently sitting on bank balance sheets to be sold as soon as bank lenders have stopped dealing with providing state-backed loans in Europe.

"I think Banks have been too busy dealing with KfW credits [firms taking debt provided by German state-owned Bank KfW Bankengruppe] as part of that country's coronavirus emergency loan scheme, than with the sale of non-performing credits," said an S&P Analyst.

Overall, German GDP for 2021 will see a strong recovery of +3.5% and +3.8% in 2021 and 2022, respectively. The fiscal policy looks set to remain supportive in 2021 and 2022 to register above +2% [Q/Q] in Q2 as well as Q3.

ITALY

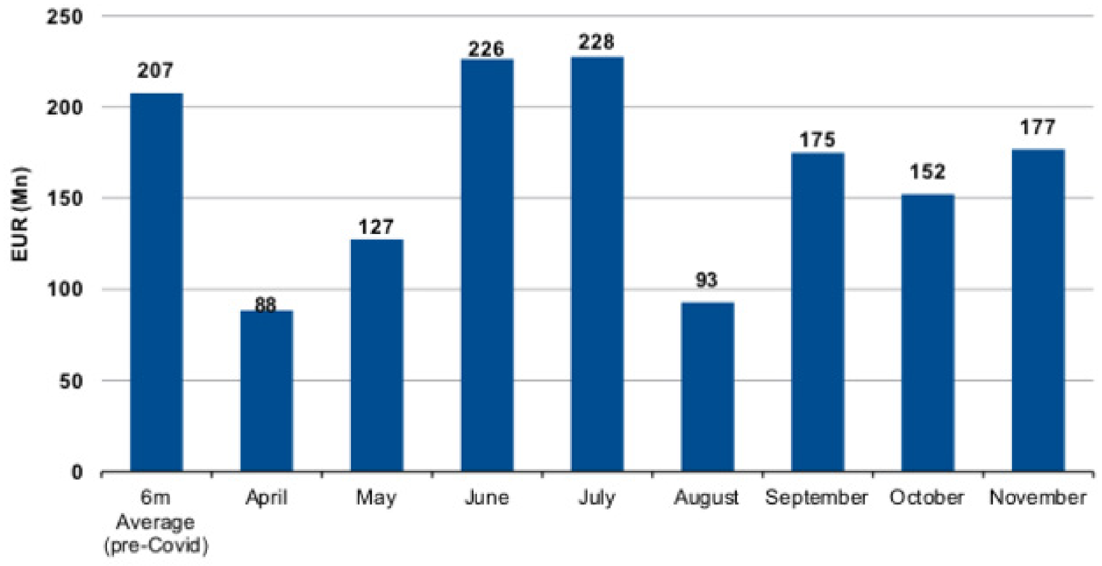
With new restrictions put in place in November, Italy was on course to fall back into recession in Q4. Economic output is therefore likely to fall by -9% this year before rebounding by +4.1% in 2021. Italy's contraction is less pronounced compared to other southern European countries, thanks to a lower share of Covid-19-sensitive services in private consumption and higher importance of the manufacturing sector, combined with a strong rebound in exports. Italian industry currently is benefiting from its position in the global supply chain, with its focus on machinery, chemicals, and high-end consumer goods, with production already back at pre-crisis levels. Italy's ambitious fiscal stimulus package has boosted public spending by only 1% since the beginning of the year vs. 3% for other large Eurozone countries. The Italian Recovery and Resilience Plan is under discussion. The proposal recently approved by the government considers additional spending of €10 billion in 2021.

The rising volume of corporate loans (+5.3% y/y the strongest dynamic since end-2011) suggests the favourable trend looks set to continue. The flow of bank loans in the first eleven months of 2020 reached €69.2 billion, compared to a negative value of €10.3 billion during the same period in 2019. It estimates that in 2020 loans grew by around €80 billion, the highest value in the last 20 years, except for 2007.

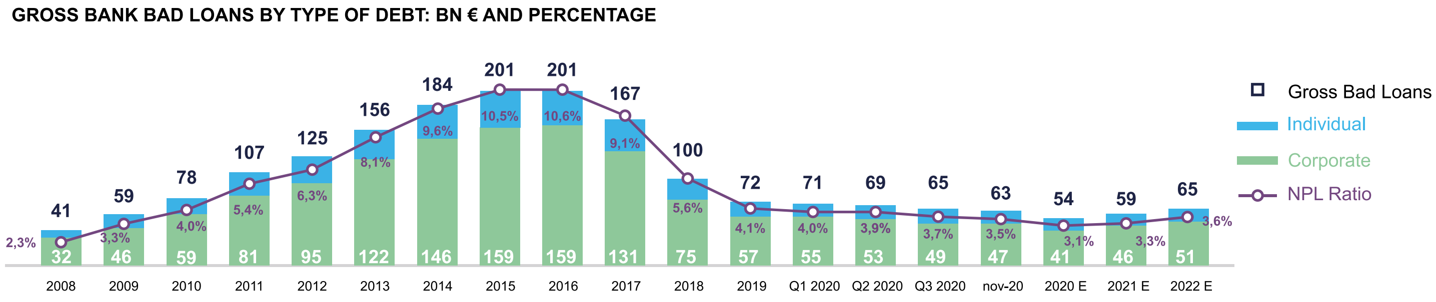
Italian banks, in response to market and regulatory pressure, have halved the total **stock of NPLs** (+/-€135bn in H1/2020 vs. €341bn in 2015 with a possible closing year due to date of a similar amount of the H1 of NPEs). **Italy reported a volume of EUR 108 billion NPLs in Q3.2020,** although this was EUR 29Bn less (-20%) than the figure recorded in June 2019 and in their efforts to reduce NPLs, Banks in Italy widely relied on nationally deployed securitisation schemes (GACS) to divest legacy loans in NPL secondary markets. 2020 records 38 Bn€ of NPL sales and 9 Bn€ of UTP transactions. The NPL amount is higher than previously expected due to the acceleration of the activity in the fourth quarter.

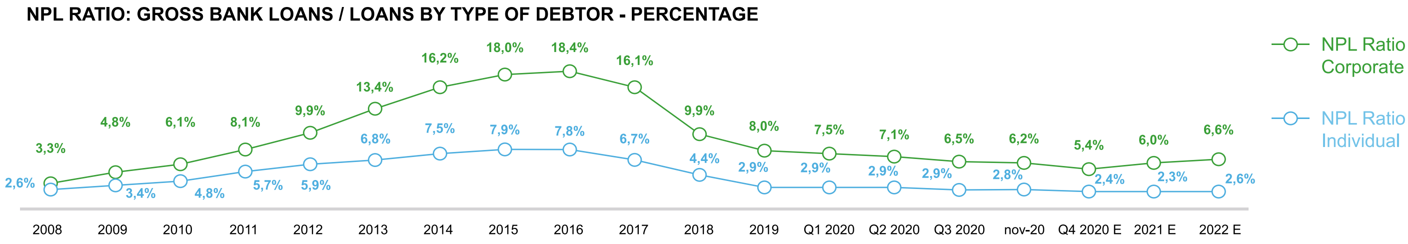
Italian NPL collections increased 16% in November relative to October, but performance remains subdued relative to pre-Covid levels. Collections picked up in June and July 2020 as the courts reopened, suffered a seasonal effect, and fell back in August, but have plateaued 10%-15% below pre-Covid levels since September. Performance' will continue to be impacted in the short term because of the slowdown in economic activity during the November lockdown. Judicial proceedings are still the main and most stable recovery strategy, while note sales remain the most volatile. When the share of note sales peaked to 24% of total collections in September, out-of-court settlements were close to their historical low (16%).

Conversely, when in October the share of out-of-court settlements peaked at 31%, note sales dropped dramatically around their historical minimum (3%). Extra-judicial strategies have suffered the most since the outbreak of the pandemic, consistently registering collections below pre-Covid volumes (Figure below). This has been driven by deteriorating economic conditions and a worsening of borrower affordability. Note sales have been more volatile. Investor demand, meanwhile, has been mainly driven by high profits and a positive long-term outlook.



In the period 2021/22 the expectation is of €30/50 billion of transactions per year in NPLs [chart below] and of €12 billion for UTP transactions. This trend is expected to continue in 2022. This entire scenario is remarkable as the Italian banking sector remains vulnerable and even state-guaranteed loans to companies, especially SMEs, are covered only by 80% on average.





Against this backdrop, expectations are for the real GDP to grow at a rate of +4.7% in 2021 and +3.8% in 2022. This in parallel with the fact that Italy's debt-to-GDP ratio is on course to reach 160% this year and will only fall to 153% by 2022.

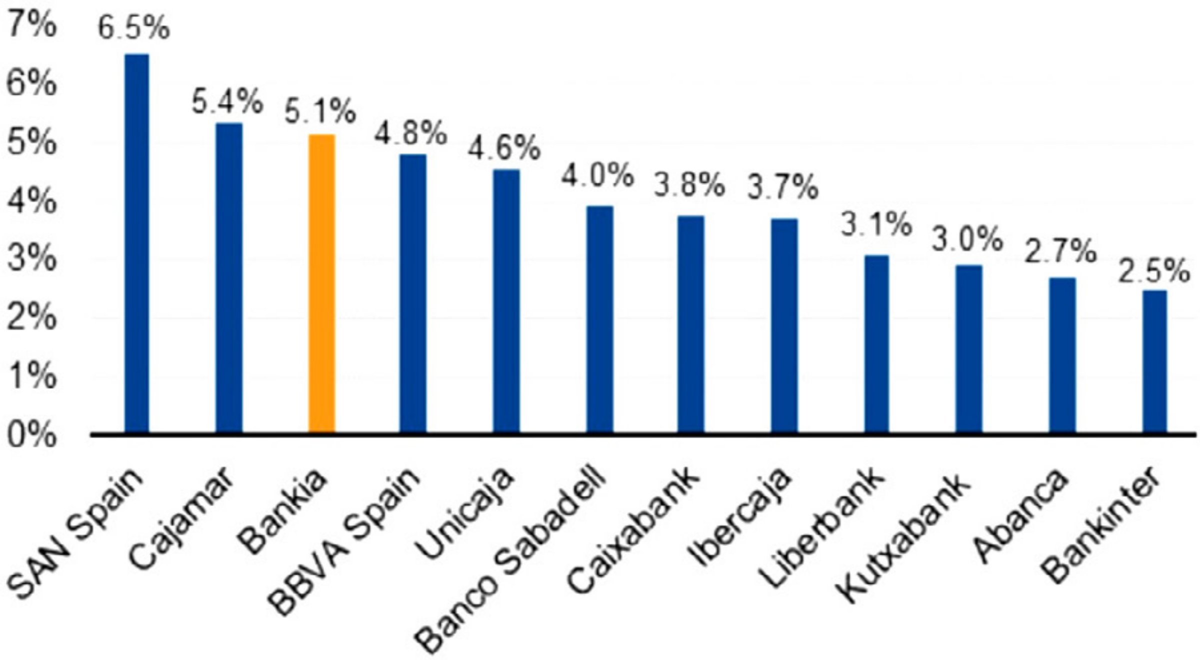
SPAIN

In Spain, restrictions will likely weigh on the short-term outlook and delay the consumer recovery, but the vaccine and ambitious stimulus are good news for the services-oriented economy. The unemployment rate likely rose 0.3 ppts to 16.7% in the final quarter. Given the poor unemployment situation in Spain, the expectation in retail sales are to slid in December by 0.5% m/m.

Only half the job losses in Spain have been recovered so far, and prolonged restrictions and a cautious reopening will weigh on consumer spending until spring 2021. Vaccination campaigns could be well advanced by summer, hence providing a boost to tourism revenues in H2. The global return to normalcy in 2022 could benefit further Spain's social spending. Therefore, after falling by -11.6% in 2020, we expect GDP to grow +5.6% in 2021 and +5.8% in 2022. Real economic activity will return to pre-crisis levels only by early 2023.

During the Pandemic, crisis activity in the NPL market fell 30% over the first seven months of 2020 but picked up considerably in July and August. With the gradual re-opening of the market, those numbers are likely to increase due to liquidity needs and Banks will put portfolios on the market for sale. July's movement was 10% below average, while by August, figures were back in line with 2019. Furthermore, other factors such as the mergers between Bankia and CaixaBank (Hermitage and Louvre portfolios) and between Liberbank and Unicaja will undoubtedly vitalize this market.

Spanish banks' NPE rations - Q2 2020



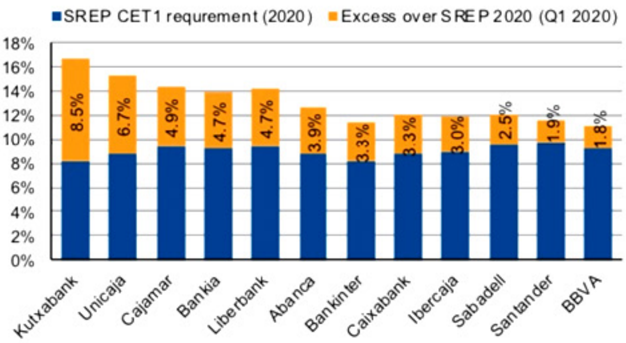
Spanish Banks entered the new crisis from a position of strength. The significant sector consolidation in the aftermath of the real estate boom-and-bust cycle flushed the weakest players out of the system, and the Spanish banking sector today comprises a handful of players with nationwide franchises alongside several regional or multi-regional banks. The decline in legacy NPL has been steady over recent years. Most banks have gross NPL ratios of under 5%, with good coverage.

By analysing 12 Banks, net NPLs have declined from €36 billion in March 2018 to €25 billion in March 2020 (Figure below). Noteworthy is that while **in September 2020, the reported volume of NPLs was €75.7 billion, while in June it was €78.3 billion, with an NPL ratio of 3,6%.** Half of this exposure sits with Santander and BBVA, the two banks best placed to absorb credit impacts thanks to their strong profitability. Recent legal developments in Spain will lead to lower cash flows and higher risk premiums. The Covid-19-induced crisis is exacerbating legal risks for Spanish NPL investors, as the need to apply debtor-protective measures is much more likely to crystallise in a recessionary environment.

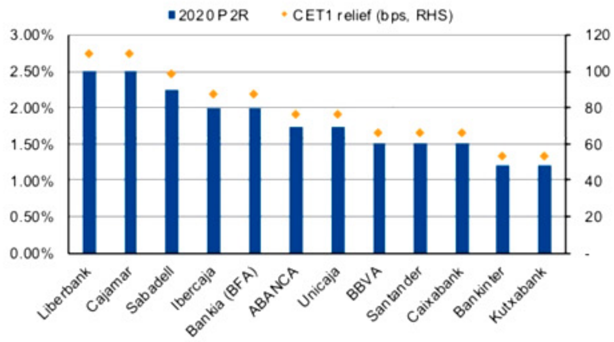
Additionally, there is still room for national and regional governments to pursue new policies that could be detrimental to asset holders. Law 5/2019 increased protection to consumers around mortgage termination clauses; Royal Decree Law 6/2020 increased levels of protection for vulnerable borrowers by extending the moratorium on evictions from primary residences by another four years (up to May 2024) and broadening the scope of borrowers protected under its provisions.

At the regional level, recent amendments to Catalonia's housing legislation are aimed at increasing consumer protection, Banks' initiatives to ensure the sustainability of their business models, including consolidation. **Banks will have to act decisively to adapt to lower-for-longer interest rates and an increasingly digitalized environment, generating more fee income to offset margin pressure as well as improving their efficiency. They will also need to undertake IT investments and process restructuring to digitalize their businesses.**

Excess capital over SREP requirement: Spanish banks



2020 Pillar 2 requirements and estimated 2021 CET1 capital relief from art 104 implementation



POST-COVID-19: A LESS LIQUID MARKET FOR SPANISH NON-PERFORMING CREDIT?

The impacts of Covid-19 will slow real estate market activity, depressing collateral values. Scope, a Rating Company, also expects a negative impact on recovery timing. Court activity and court deadlines in Spain were suspended from March until the end of April. While legal proceedings will be resumed gradually, Spanish courts will probably not prioritise foreclosure or bankruptcy proceedings. Investors will likely take more conservative views on their projections for recoveries, both in terms of timing and amount, leading to a widening of the bid-ask gap, and reducing liquidity for Spanish non-performing credit.

«We have had very few defaults so far year to date among the Spanish companies we rate, but this is likely to change within the next 12 months. We have identified several Spanish companies with very fragile credit profiles, weak liquidity, high leverage, and subdued operating performance. The risk of default for these companies is particularly high. Companies and financial sponsors may be tempted to repurchase debt at distressed prices, which could be considered as default according to our methodology» states Moody's.

BANKRUPTCIES:

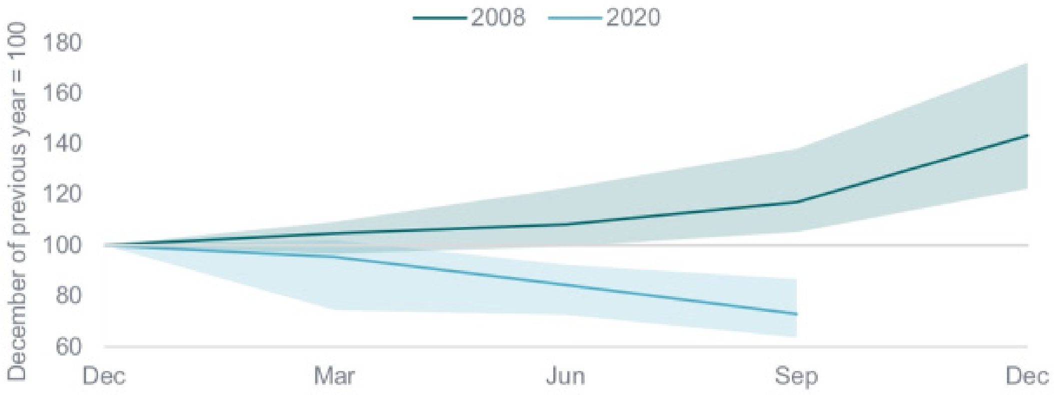
Corporate default rates haven't risen as much as during the global financial crisis over a decade ago. This can be seen by comparing their trajectories, starting in July 2008 (two months before the bankruptcy of Lehman Brothers) and January 2020 (two months before the lockdowns this past spring).

Forecasts provided by Moody's suggest further increases in the months ahead, but a peak well below that of the global financial crisis. That is primarily because central banks have kept the liquidity taps wide open to mitigate credit impairment while ensuring cheap funding for governments to provide large-scale fiscal stimulus. Defaults should be concentrated within the sectors most affected by the virus: gaming, hotels, autos, retail, energy, and advertising-dependent media. The more resilient sectors are technology, telecommunications, consumer, and non-cyclical.

Whilst the policy response to the crisis has prevented an immediate spate of bankruptcies, there is a limit to how long central banks and governments can hold back the tide. The consensus is not clear on this matter, but it's developing going forward. However, investors will put themselves in the best position to ride out the coming default wave by focusing on debt that is backed by strong assets and the potential for cash flow generation.

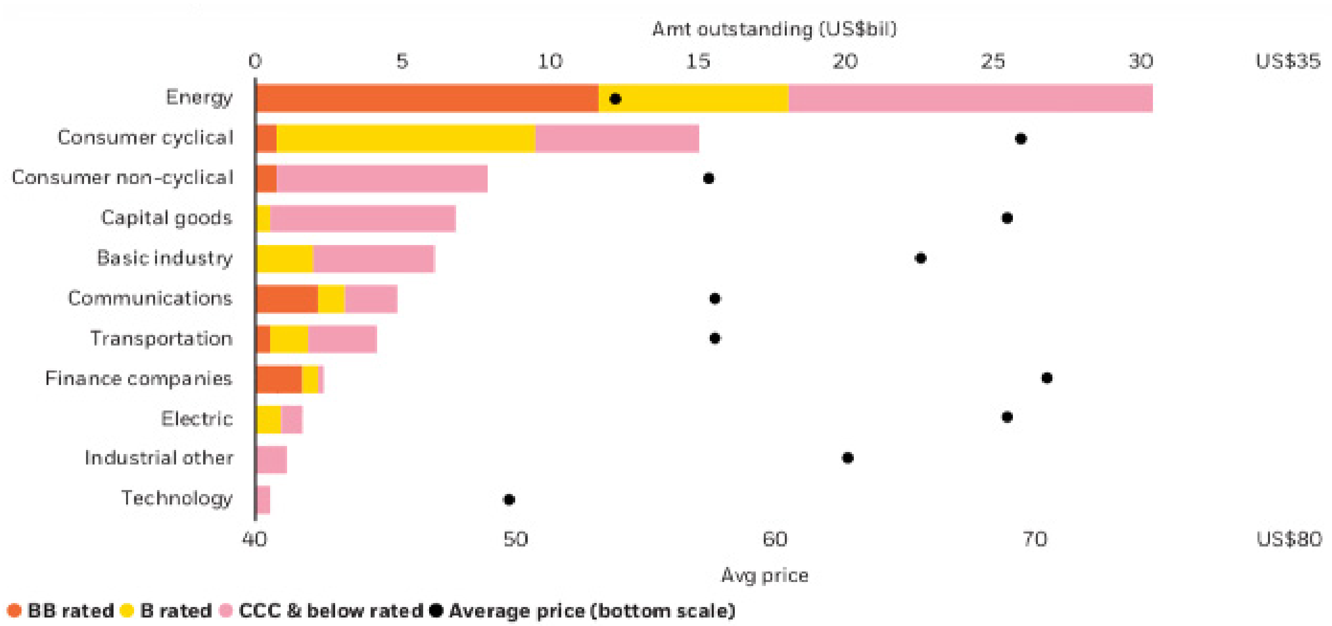
Another important factor that is delaying defaults is a technical one. Countries such as France, Germany, and the UK have altered their bankruptcy regimes: the former two nations suspended the obligation to file for bankruptcy until 30 September 2020, while the UK introduced the Corporate Governance and Insolvency Act, which temporarily suspended wrongful trading provisions and introduced a moratorium of up to 40 days to allow firms to pursue rescue plans.

The number of bankruptcies during the 2008 global financial crisis was much higher than it has been during the current Covid-19 pandemic



Source: Quintet, FactSet; chart shows median and min/max range (US, UK, Germany, France, Spain, Netherlands, Sweden, Finland, Denmark, Norway, Japan and South Korea)

Distressed debt by sector



CONCLUSION

Being several months into an economic downturn brought by the emergence of the pandemic, an accumulation of non-performing loans (NPLs) is expected in Europe that is projected to hit €1.4 trillion by the end of 2022. However, the various job retention schemes and business protection measures are masking the true magnitude of the coming crisis and the veil will be lifted only when furlough and moratorium schemes conclude.

It becomes apparent that to keep liquidity it is necessary to clear now those legacy impaired assets stemming from the global financial crisis, preparing for the new crop of pandemic-related NPLs.

Lenders have realised they need a more proactive approach to NPLs. For that, they need digital and analytics tools. But those tools are often missing. Therefore, their current ability to manage NPLs now needs to improve, and fast.

HOW QUALCO CAN HELP

QUALCO offers a holistic solution for proactively managing NPLs and impaired assets. The QUALCO 360 technology ecosystem aggregates data from multiple sources and uses the best ML and AI analytics to give creditors a 360-degree view of a customer's past, current and expected financial situation. It also provides omnichannel engagement tools and recommendations for debt restructuring and servicing for the best net results. QUALCO 360 enables clients to turn this data and insight into meaningful actions and credit operations, allowing the business to mitigate risks in areas of high exposure.

QUALCO 360

A CONSTANTLY EXPANDING TECHNOLOGY ECOSYSTEM

QUALCO 360 is a constantly expanding technology ecosystem that enables you to rapidly align operational activity with ever-changing customer behaviour. Combining analytics with Machine Learning and a comprehensive collections system it revolutionises the management of NPLs and NPEs and radically reduces losses.

With QUALCO 360 you get:

- ✓ Greater efficiency and productivity
- ✓ Increased ROI
- ✓ Reduced Losses
- ✓ Single view of clients' state and actions
- ✓ Streamlined information
- ✓ Seamless systems interaction
- ✓ Optimal Customer Experience

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- IMF
- International Institute of Finance
- JP Morgan Research
- Macrobond Research
- McKinsey
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- PwC
- S&P Ratings
- Scope Ratings
- University of Frankfurt
- Wimmer Research Unit
- World Economic Forum

ABOUT QUALCO

For more than 20 years, we help organisations adapt to a constantly changing credit risk and distressed asset landscape driven by economic, regulatory, and behavioural considerations at both global and local levels. Our technology comprises enterprise-class, highly scalable, end-to-end systems that drive our 70+ clients around the world to new levels of efficiency. We're investing in explainable AI and Machine Learning to make sense of our client's data by bringing predictive insights to their operations. Learn how you can improve liquidation, reduce credit risk and mitigate losses through technology and innovation at **www.qualco.eu**