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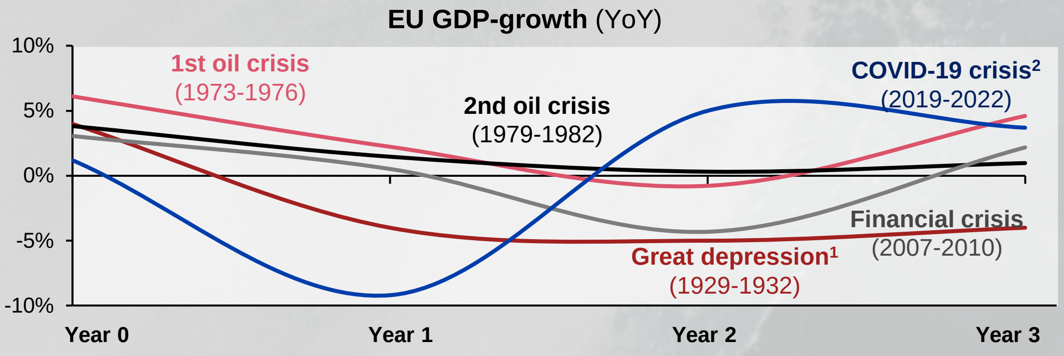
Distressed debt perspective

How to prepare for a new wave of non-performing loans

2021

Banks are increasingly confronted with the negative effects of the COVID-19 pandemic and its control measures on the real economy

COVID-19 pandemic could result in one of the most severe crises in modern history

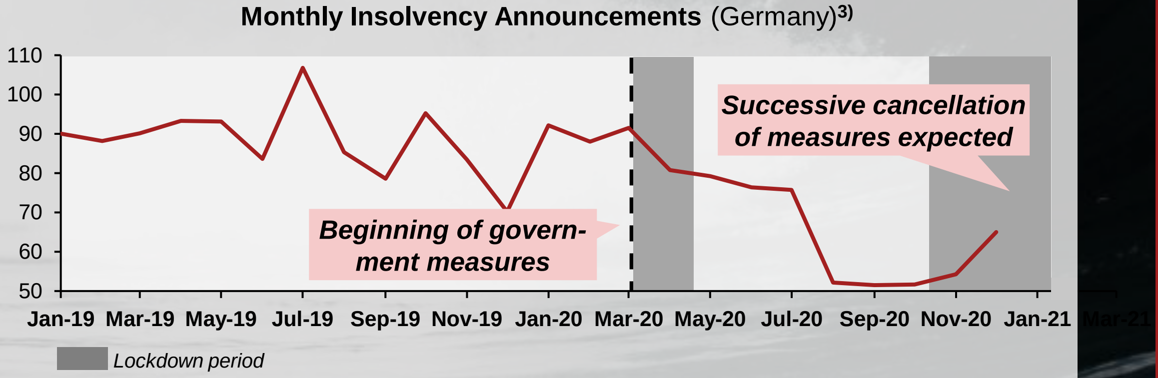


Corporates in some industries were already facing economic challenges before the pandemic

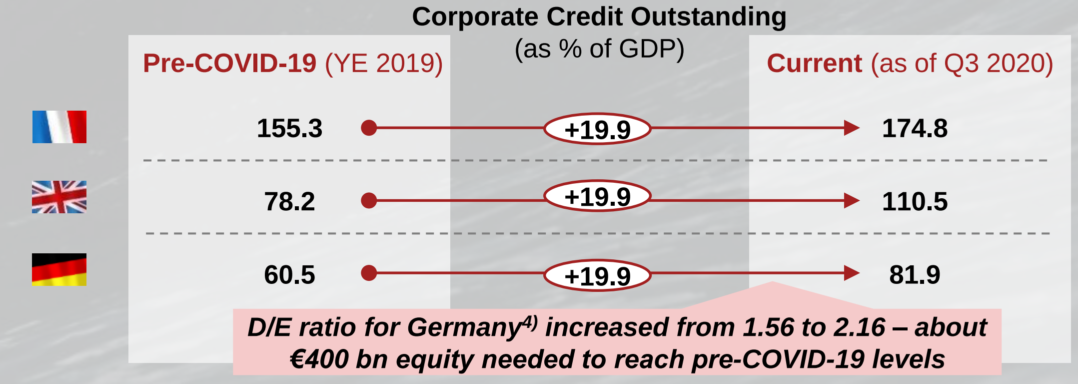
Selected industries (Germany)	Probability of Default (2019YE vs. industry average)		Liabilities/Turnover (2019YE vs. industry average)	
Automotive	1.0	-0.06 ppts	46	-7 ppts
Industrial manufacturing	0.9	-0.15 pts	44	-9 pts
Cons. goods & retail (food)	0.9	-0.16 ppts	43	-10 pts
Cons. goods & retail (non-food)	1.1	+0.03 ppts	34	-19 ppts
Entertainment & media	1.2	+0.13 ppts	64	+11 ppts
Pass. transp., travel, hospitality	1.8	+0.79 ppts	70	+18 ppts

Delta 2019YE vs. x-industry average (based on 14 industries)

Due to government support, increases in insolvency rates could be prevented – many measures expected to end in 2021



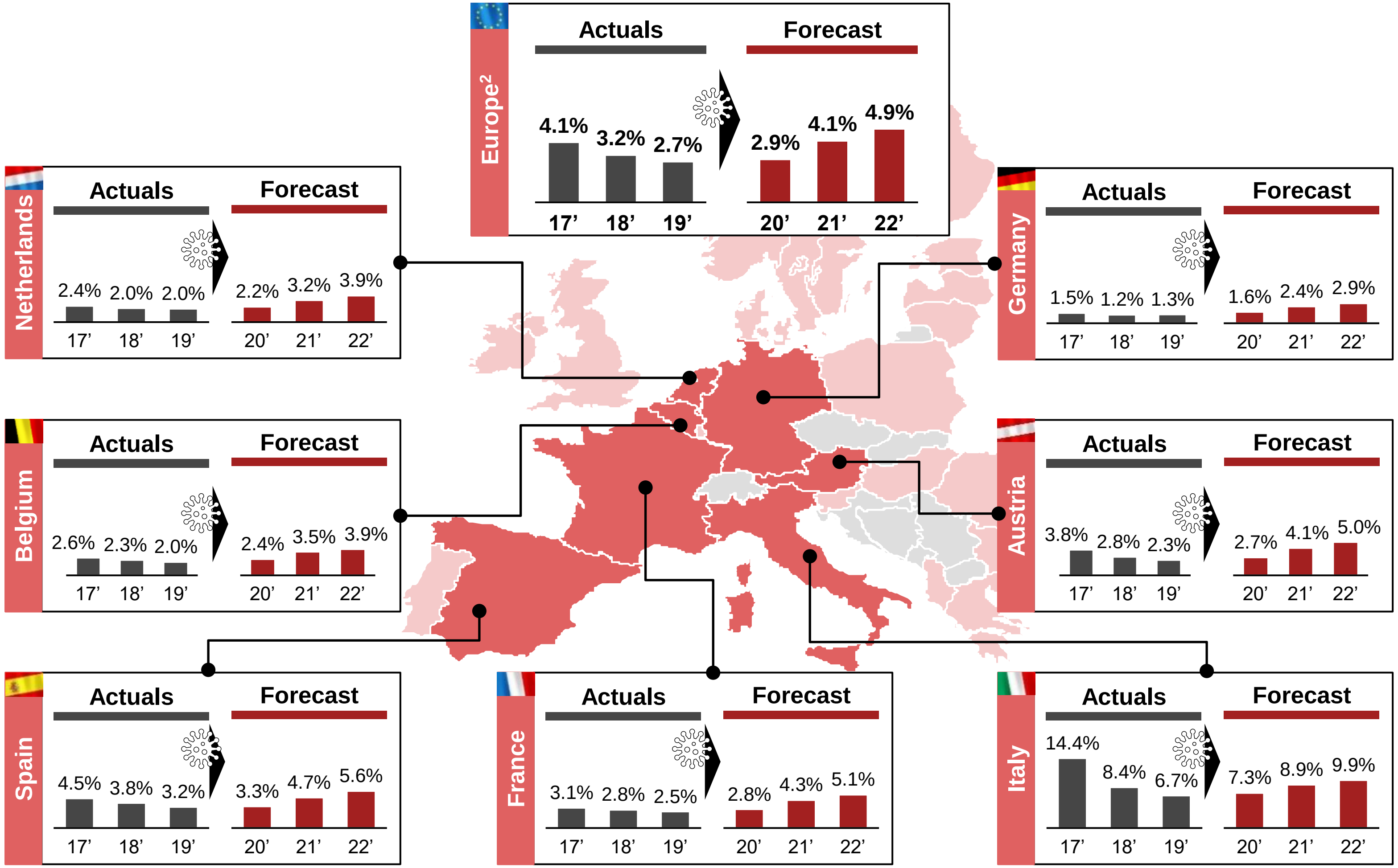
Corporates soaking up debt – significant equity injections required to reach pre-COVID-19 levels



1) Global GDP growth 2) Scenario I 3) I100=2015 4) Total debt divided by total equity of all German corporations
Source: Strategy& analysis, Bloomberg, Quantic financial, destatis

As public support measures come to an end, NPL volumes are expected to increase sharply due to pandemic-induced defaults

COVID-19 impact[1] on NPL levels of selected European countries



Perspective

- According to **model-based scenario analyses**, pandemic-induced defaults expected to significantly **increase non-performing loan (NPL) volumes**
- **Regulatory measures** and **state support** hide deteriorating asset quality in bank books and stabilize NPL ratios in 2020
- **Full impact of crisis** is expected to emerge in 2021 and 2022 when many support measures are scaled back[3]
- **Variability of ticket size** with new NPLs ranging from SME to large corporate exposures

Disclaimer: High levels of uncertainty for actual NPL volume development due to dependency on (short-term) government intervention and banks' NPL strategy

1) Scenario I: Effective vaccination 2) All countries marked in red/ light red in scope 3) E.g. German short-time work benefits are planned to expired end of 2021
Source: Strategy& analysis, EBA

Rising NPL volumes will significantly decrease new lending activities of European banks – NPL resolution required

Distressed debt impact on new lending activities

Impact of distressed debt on lending

Estimated increase in the NPL stock of European banks[1]
(until 2022)

from 2.9% to 4.9%
NPL ratio

Estimated impact

-25%[2)]
new lending

New corporate lending activities of European banks[1]
(2022)

Benefits of distressed debt resolution for banks

Improving financial position

- **Release of capital** to drive new and profitable lending activities
- **Decrease of CET1 risks** associated with uncovered NPL positions
- **Reduction of funding costs** related to coverage of risky NPL portfolios

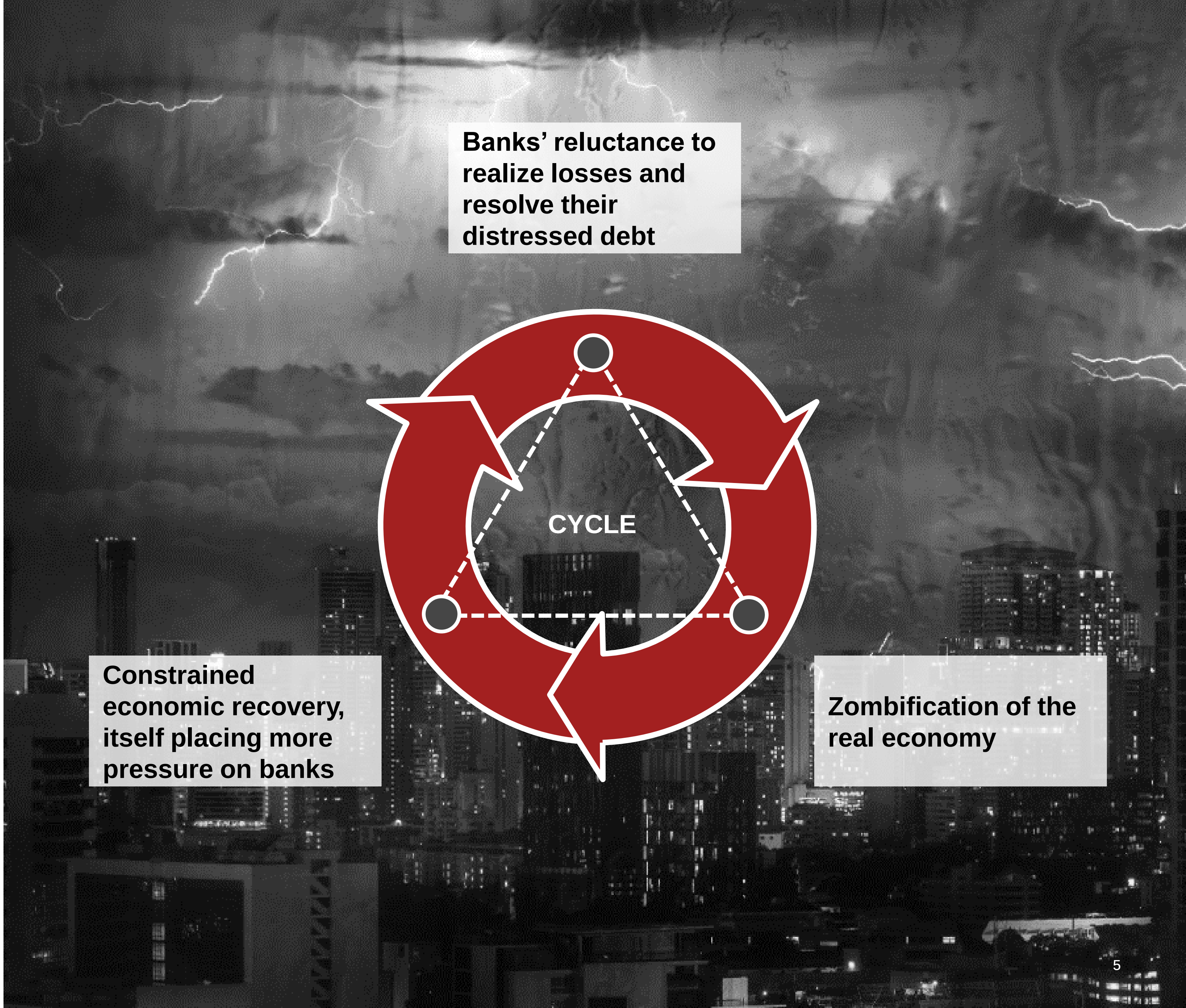
Enhancing operations

- **Clear** and **credible basis** for **financial planning** – also for (potential) investors
- **Reassignment of staff** otherwise allotted to costly workout of NPL exposures
- Overall **reduction of uncertainty** in the banking sector and reinforcement of its resilience

1) EBA sample 2) Estimated annual decrease in 2022 compared to baseline;
Source: European Central Bank, Banco de España, Strategy& analysis

Europe is facing another decade with ailing banks unless upcoming wave of distressed debt can be swiftly resolved

CYCLE OF NON-RESOLVED DISTRESSED DEBT



Broad range of options to resolve new wave of distressed debt can be classified in government-led vs. market-led solutions

Overview of resolution options

1 GOVERNMENT-LED

- Banks dispose of distressed assets **to central resolution entity** (normally initiated by the government**)**
- Resolution entities **manage workout of disposed assets**
- Two possible central resolution options for **EU-wide solution**
  - **Setup** of **EU-wide** or **state-specific asset management companies** (AMCs)
  - **Central bank** acting as **direct buyer**

2 MARKET-LED

- Banks dispose of distressed loans to **private investors** through **market transactions**
- Disposals either through **large-scale portfolio transactions** or **individual loan trades**
- **Private investors**[1] to manage workout of loan portfolio and drive value creation

Key enabler

State support e.g. through favorable pricing and risk sharing mechanism

Key enabler

Standards for distressed secondary markets for Europe

1) Institutional investors, alternative investors (PEs, hedge funds), banks
Source: Strategy& analysis

While market-led solutions are more flexible, state funding may be easier to implement in a government-led setup

Assessment of resolution options

	1 GOVERNMENT-LED	2 MARKET-LED
Key benefits	• Highly efficient in acquiring distressed debt and deleveraging struggling banks • State funding can be easily implemented and might help to close the pricing gap	• Tailored asset selection and flexible matching of investors and banks with aligned interests • Lower political barriers for implementation • Efficient and value-preserving workout utilizing market intelligence of investors • Flexibility to address individual servicing requirements of specific loan portfolios
Potential challenges	• Legal and political challenges during implementation process • Misalignment of interests between diverse set of shareholders may impede decision making and workout processes • Alternative funding through involvement of private investors potentially challenging (asset selection, etc.)	• Sufficient interest from investor side as a prerequisite • Pricing gap offering limited incentive for banks to sell their exposures of distressed debt • Targeted state support for specific industries / sectors (e.g. those that have been hit most severely by COVID-19) more difficult to implement

Source: Strategy& analysis

Priority topics for banks

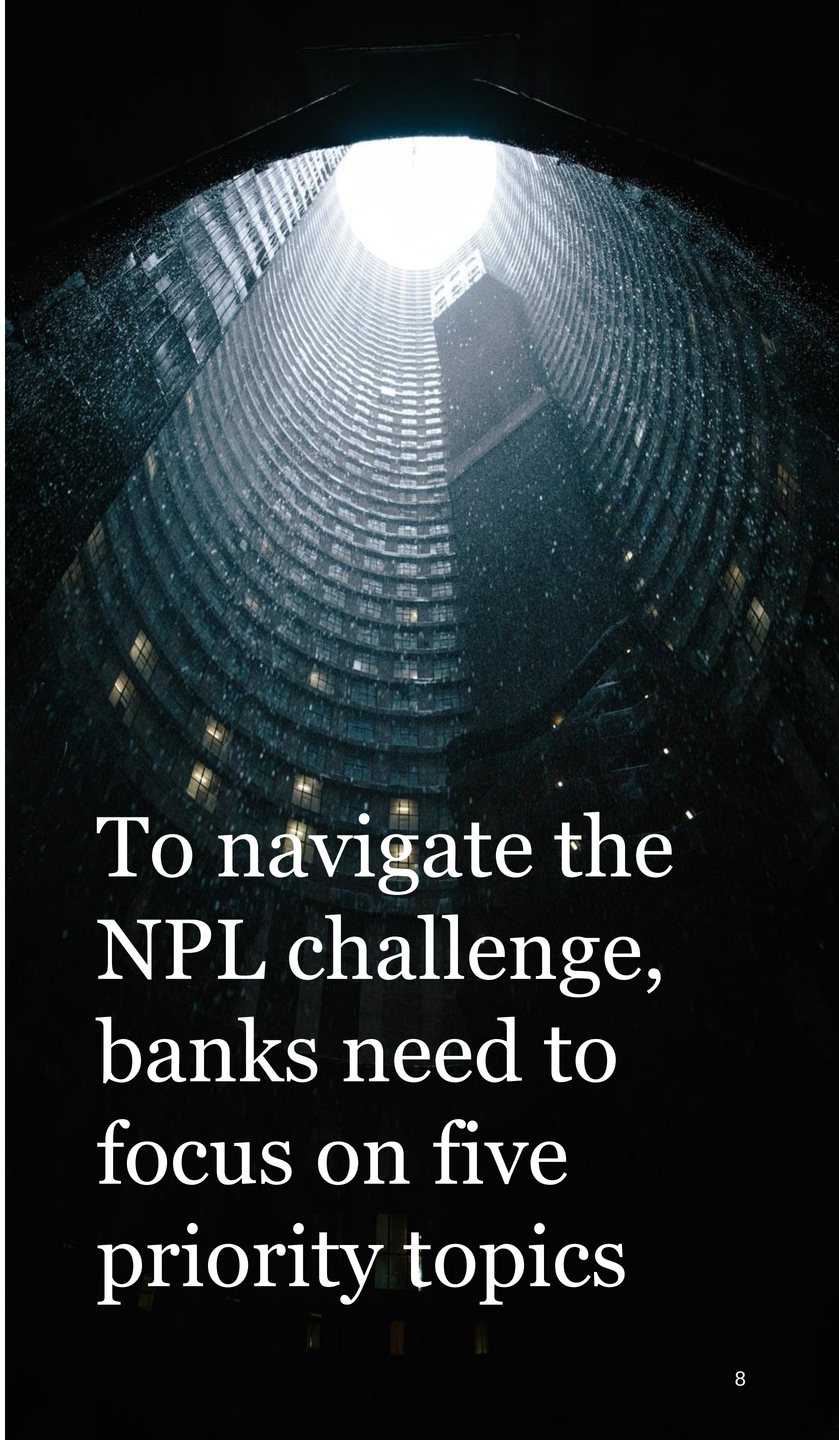
1. Strengthen **early warning systems and** identify most **significant risk drivers**

2. Resolve **organizational** and **capacity constraints** to ensure that workout and restructuring lifecycle is sufficiently flexible

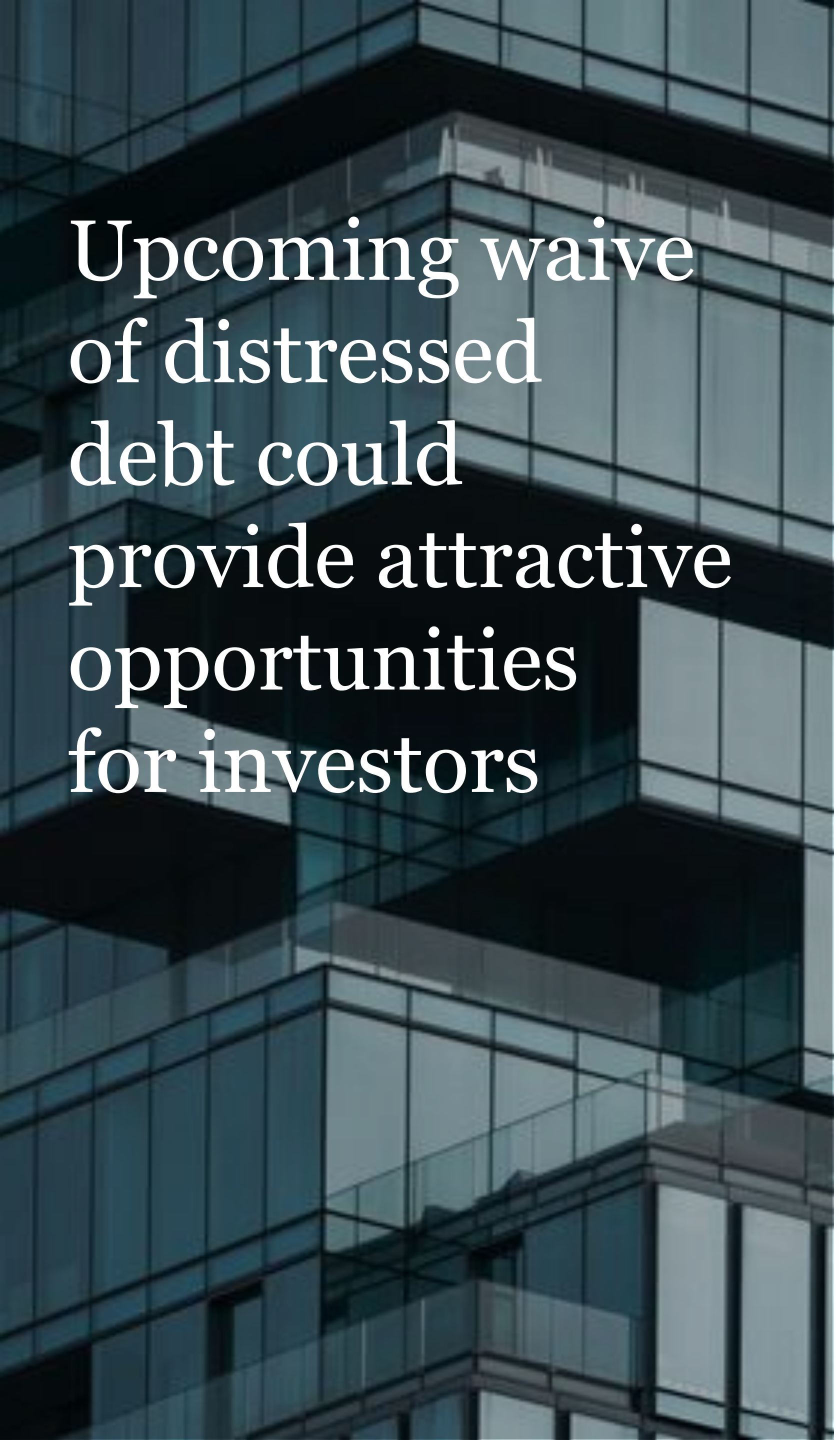
3. Ensure **robust governance and decision making**, and convey clear guidance to front office as well as recovery units

4. Develop perspective on expected distressed debt levels **in own portfolio** and **identify capital impact**

5. **Strengthen exit management capabilities** to facilitate potential deleveraging of distressed debt from balance sheet



Source: Strategy& analysis



Upcoming waive of distressed debt could provide attractive opportunities for investors

Priority topics for investors

1. Refine **distressed debt investment strategy,** e.g. regional or industry focus, single tickets vs. portfolios, quality of loans
2. Establish **clear distressed debt management strategy,** e.g. internal management vs. trading of loans and **build required in-house competencies**
3. **Develop strategic partnerships** with other **investors** or **banks** to source new investment opportunities in the market ahead of the curve
4. **Increase operational flexibility** for upscaling special **capabilities to service distressed loan portfolios** (internal vs. external)
5. Build **restructuring capabilities** to increase return from distressed loan portfolio where possible (e.g. Stage 2 loans)

Source: Strategy&

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