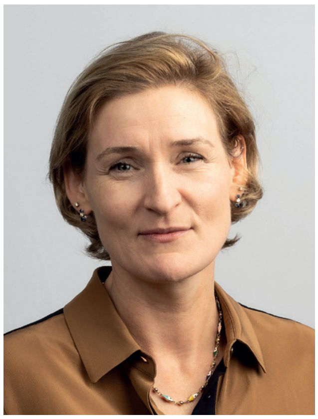
E X P E R T Q & A

*Today's market is characterised by optimisation by banks of their balance sheets in the face of changing capital and provisioning rules, with private credit stepping in to fill the gap, says Toni McDermott, credit and lending CIO at Arrow Global*



# Banks seek out partners for European NPLs

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### Q What are the key drivers of growth in distressed debt investment opportunities across Europe?

European banks are under continued pressure to optimise their balance sheets and improve return on equity, driven by changes in capital rules with the implementation of Basel 3.1, as well as the full impact of IFRS9 and expected loss provisioning earlier.

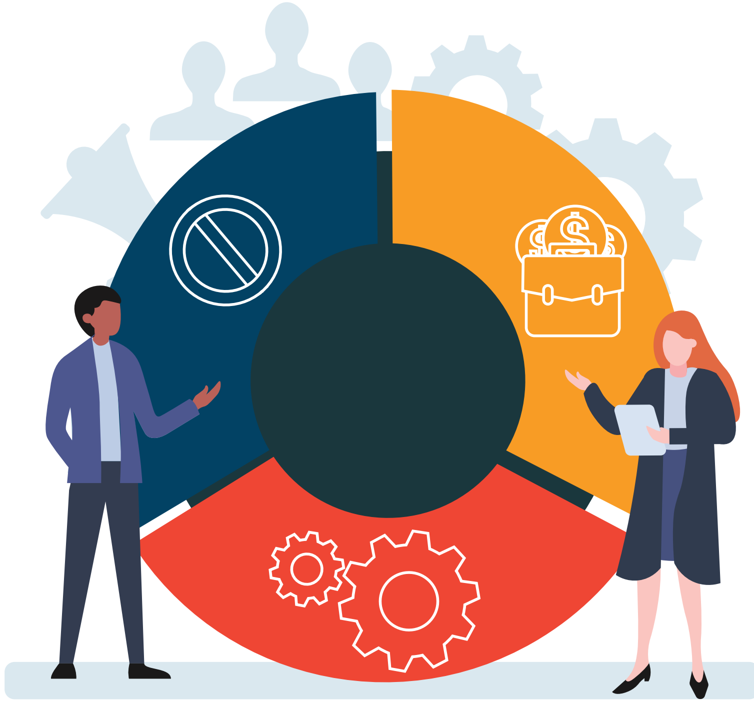
While the new provisioning rules are already in place, the new capital rules will have material ramifications and are being phased in to give time to banks to adapt their business models to move away from less capital-efficient business lines and towards areas like mass-market standardised residential lending, which has potential to have significantly better treatment.

As a result, rather than frequent large scale non-performing loan portfolio sales as were seen in the years after the global financial crisis, we see the current opportunity in two areas: continuous local engagement with banks to manage their stage 2 and stage 3 assets; and addressing the funding gap left by bank retrenchment from non-mass market real estate and other speciality lending.

### Q What does it take for private credit to benefit from those opportunities?

Banks have shifted towards more mass market products such as retail mortgages, and retreated from more capital- and operationally-intensive sectors such as speciality finance. This has created an opportunity for private credit providers with the necessary experience and operational capability to fill the gap. Arrow has been building up our locally-led real estate lending franchise for a long time in the granular, operationally heavy residential bridge and development lending sectors, which has become increasingly a focus for investors.

Alongside regular NPL sales, stage 2 loans are being pre-emptively refinanced or sold earlier in the value chain because, for example, they no longer meet banks' loan-to-value or interest coverage requirements or are operationally challenging to manage. Banks require local partners with real estate and credit expertise who can navigate and unlock these complex situations.



### Q Which sectors are likely to see a rise in non-performing loans, and why?

We are still very cautious on office, particularly in secondary or tertiary locations. We are closely watching for signs of stress on the consumer, like everyone else. While increases in the cost of living have had an impact, we don't anticipate a significant wave of consumer non-performing loans.

We are experts in real estate, whether from a primary lending, opportunistic credit or equity perspective. We are very busy across all that spectrum. We are primarily focused on residential assets as described before. We also see specific local opportunities in other sectors such as tourism and daily-needs retail, with attractive entry prices for assets that have shown resilience in recent years. We manage assets for more than 200 banks, positioning us as a go-to buyer locally when they seek to divest or refinance to optimise their balance sheets.

**Q How do distressed debt and non-core banking assets influence the current European private debt market?**

We have witnessed huge growth in direct lending over the past decade, with corporate credit being the primary driver. More recently because of the shifts described earlier, private credit has expanded into asset-backed strategies, where we have been active since 2005.

This has the potential to be much larger than corporate credit because it finances, by its nature, the broad economy and offers more diversified exposure with lower correlation to broader market movements.

**Q As asset-backed lending evolves, what are the emerging opportunities and challenges?**

The potential in asset-backed lending is enormous, as it can encompass financial assets (like receivables arising from consumer or auto loans and leases), hard assets (like aircraft and infrastructure) and real estate.

For us, the focus remains primarily on residential real estate, where values are underpinned by chronic undersupply in the face of growing demand, poor quality of existing housing stock needing an upgrade and lack of alternative financing from banks. Tighter bank lending conditions have created a €176 billion funding gap in Europe for real estate over the next three years alone and significant refinancing opportunities beyond that.

The challenge is that asset-backed lending is granular and local, especially in Europe, requiring operational capability and relationships built up over many years. It is very different from mid-large cap corporate lending. For us, being senior and close to the assets is preferable, with mortgage security or assignment and bankruptcy remote structures.

*"Banks have retreated from more capital- and operationally-intensive sectors such as speciality finance, which has created an opportunity for private credit providers"*



*"Sixty-five percent of European housing stock is more than 45 years old, requiring upgrading – private capital will have a meaningful part to play"*

But this is not something that you can wake up one day and decide to do because it takes quite deliberate positioning and investment. It is our long-standing ownership of our local lending and investment franchises that allows us to access and manage these opportunities with attractive risk/reward profiles.

**Q How can debt providers support the green energy transition through real estate lending in Europe?**

The scarcity of housing at affordable levels is a shared problem across Europe, which has been decades in the making, despite fundamental differences between housing systems. In addition, 65 percent of existing European housing stock is more than 45 years old, requiring upgrading to meet EPC standards and their equivalent across Europe.

Private capital will have a meaningful part to play in addressing these issues. We have positioned ourselves over several years to be present locally with the necessary operations and expertise to be able to do this.

**Q Finally, how do you see the role of institutional capital evolving in this space moving forward?**

As mentioned, investors are increasingly focused on asset-backed strategies, which has the potential to dwarf corporate credit and bring benefits in terms of lower correlation and diversification.

Within that, real estate lending and value-add strategies are attractive in the current market, which is characterised by high base interest rates (even if we are off the peaks), stable credit spreads and robust structures. Investing in and financing assets in Europe, especially real estate, requires local language, market, regulatory, tax and legal expertise, which is where Arrow's strengths lie. ■