German Non & Sub Performing Loans

"Their Re-Awakening as an Alternative Investment"

December 2021

This "*White Paper*" looks at the opportunities within Germany emanating from the current economic environment, with specific reference to Distressed Debt and Special Situations, principally Non & Sub Performing Loans ("**NPLs**") which are underpinned by German real estate.

Further the "*White Paper*" seeks to provide an investor with a route map to understand the current NPL sector dynamics whilst providing signposts as to how to extract value over the short to medium term from the asset class whether directly through the debt security or indirectly by actively managing the underlying real estate security.

The key facets of the paper regarding the Distressed Debt sector today can be summed up in three words:

Awakening, Realisation & Solution.

I. Executive Summary

- The current market situation calls for the adoption of a proactive stance to the inclusion of NPLs within an investment portfolio. This position is being reinforced by the pre-emptive actions being undertaken by the European Central Bank and the European Commission to assist facilitate and enhance the NPLs market's development.

- A re-awakened Alternative Investment resulting from a combination of a number of key extraneous factors:

  - Regulatory and fiscal factors requiring Banks to have enhanced focus on risk management, capital adequacy & income quality.
  - COVID 19 – a catalyst heightening need for banks to resolve and proactively manage their loan books.
  - Emergent & defining trends impacting the underlying security, principally within defined real estate sectors.
  - Loan & asset defining influence of Environmental, Social & Governance ("**ESG**") on quality of security and management operational processes.

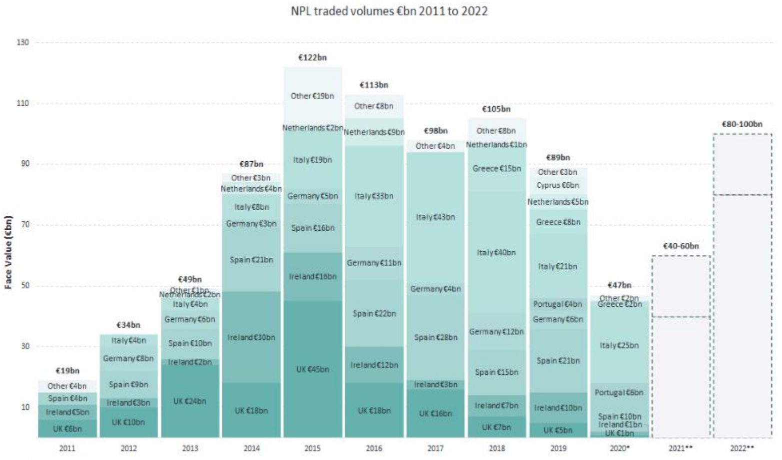
- Opportunities for resolution need to be focused on partnerships with requisite experienced management capabilities to ensure maximisation of value for all stakeholders.

- Clear prospects for value creation through providing solutions by unlocking underlying real estate to align with current & future market sustainable needs.

- The past delivers ideas for future opportunities within the NPL sector; but only with knowledge transfer & good management capabilities will value be created.

II. Current Market Overview

Having had c.12 years of financial stability post the Global Financial Crisis ("**GFC**") of 2007/8, reflected in sustained economic growth across all key sectors & markets (including real estate), we now find ourselves in an unchartered economic & financial environment post COVID 19.



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

In Europe, the massive EU recovery fund fiscal package (€750 billion) continues to be held up, lending crucial support to the stabilisation of economies. Despite intense risk aversion in financial markets, lending standards eased, and credit expanded into mid-2020, benefitting small and medium sized enterprises. This credit expansion prevented insolvencies of firms that, at the time, faced liquidity shortages. At the end of 2020, public loan guarantees covered between 2 to 7% of GDP in the four largest euro-area countries, explaining most of the credit growth. These loan portfolios will inevitably be associated with substantial credit risk, though this may only materialize once support measures are phased out.

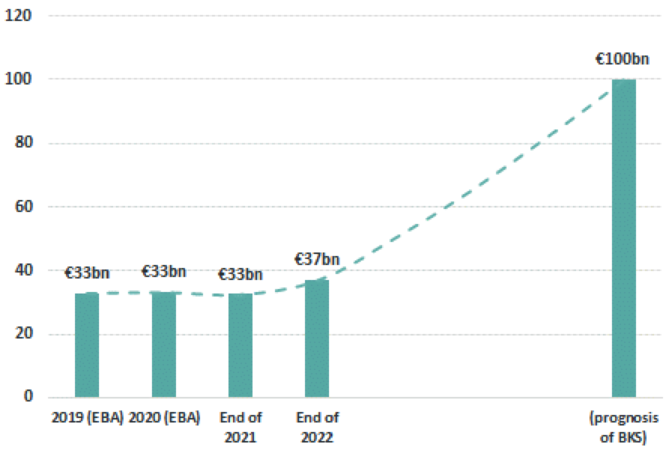
Whilst the support measures were essential, they have created a challenge for the banking system across three key areas: reporting of bank's asset quality, the recognition of forward-looking credit losses (IFRS9) and the scrutiny of bank's ability to manage NPLs.

In the wider economy, in 2021, after a further decline in GDP during the first quarter caused by the many restrictions in place, a recovery was seen in the second quarter assisted by the roll-out of vaccines, and governmental actions, with the real GDP advancing between a projection of 3 to 4%. Whether the positive momentum continues considering the recent identification of the Omicron strain, and the associated governmental policies being enacted is too soon to tell.

Against this backdrop, looking forward PWC estimates that NPLs with a face value of around €150 billion 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.

In an adverse scenario, the ECB has estimated that the amount of NPLs in the Euro area might reach €1.4 trillion by the end of 2022; whilst the Eurozone NPL ratio (6/2021) is currently at 2.32% it is expected to increase to + 4.0% by the end of 2021. This would put circa €255 billion of additional NPLs on Eurozone Banks' balance sheets by the end of 2021.

While the European Banking Authority (EBA) put the total of NPL inventories of German Banks at €31.2 billion in the 2nd qtr 2021, with the market players expected an average increase of up to €32.6 billion by the end of 2021 and to €37 billion by the end of 2022.“**We continue to expect the absolute figures (*in Germany*) to triple to more than €100 billion 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 represent 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 and investing in NPLs.



Expected NPL volumes in German banks for the years 2021 and 2022
Sources: EBA / BKS

III. Awakening

i) Regulatory

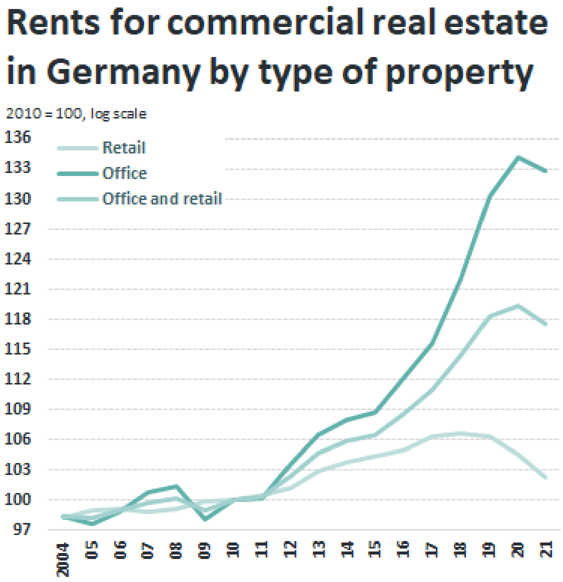
NPLs are increasingly becoming the focus of international and national supervisors. The EBA, for example, sees holdings of NPLs at a number of banks in member states throughout the Euro area (in addition to equity development) as one of the main risks for financial institutions. Correspondingly, in June 2021, the German AFS *Ausschuss für Finanzstabilität* - Financial Stability Committee (consisting of the German Federal Ministry of Finance, *Deutsche Bundesbank* and the Federal Financial Supervisory Authority (*BaFin*)) made the following key statements at the national level in its "*8th Report to the German Bundestag on Financial Stability in Germany*":

- As the COVID 19 pandemic progresses, it cannot be ruled out that insolvencies in the corporate sector and the associated losses in the banking sector will increase. The banking sector, policymakers and supervisors should prepare accordingly for the eventuality of rising corporate insolvencies.

- There is a vulnerability of the German banking sector in the possible overestimation of the value of collateral across sectors including commercial as well as in residential real estate loans (especially in urban locations). The value of collateral in residential real estate loan portfolios may be overestimated, leaving the banking sector vulnerable to price declines in the residential real estate market.

- Depending on the further course of the COVID 19 pandemic, rent defaults and price declines in the affected segments of the commercial real estate market could also intensify. Recent ECB data confirms such trends in the retail and urban commercial real estate sectors. Also, the COVID 19 pandemic will accelerate social trends such as online shopping and home offices, which may lead to losses in Banks' loan portfolios.

- The German banking sector is vulnerable to negative developments in the commercial real estate market. This vulnerability is due to the significant share of risky commercial real estate loans. For example, survey data showed that 22% of new loans originated in 2018 were unsecured. For historical loans, the share of unsecured loans is significantly lower at 12%. In addition, 37% of newly commercial real estate loans originated were at a variable interest rates. Among significant institutions 62% of new commercial real estate loans were financings from special purpose entities with limited or no recourse to shareholders. In this case, the bank has limited recourse to collateral in the event of default on the loan. In addition, a considerable proportion of the new loans granted were for project finance (construction project loans) which have final maturities. This means that they do not have to be repaid until the end of the contract period. This tends to increase the risk of loss for the bank.


Rents for commercial real estate in Germany by type of property

Source: vdpResearch GmbH

Hence, **in contrast to the GFC in 2008, this time the negative impetus is coming from the real economy**. Banks that have not yet had extensive experience with NPLs (and, consequently, do not have internal workout capacities) may therefore also be affected. This is a further motivating factor for the sale of NPL single tranches as well as portfolios.

In addition to the expected catalyst effect from the COVID 19 pandemic, **the implementation of IFRS 9 will additionally require higher and earlier risk provisioning** compared to IAS 39, which in some cases will exceed the regulatory expected losses, thus leading to an impairment surplus and providing further motivation for NPL sales.

Outside the regulated bank exposure to the real estate sector, are debt investments made by the non-bank investors, i.e debt funds, insurance entities, where often they have taken positions somewhat higher up the risk curve, searching for yield, yet without the necessary expertise to manage such exposure in a downturn. Such market exposure is not included in the official data albeit will have an impact, as yet unknown, on the development of the NPL sector.

Consequently, the establishment of a comprehensive strategy to address the issue of NPLs is a priority for both, the European Union and the Member States. **On 7 June 2021, European Parliament negotiators agreed with the European Council** on common EU standards regulating the secondary market for non-performing loans. The purpose of the proposed directive (based on the proposal for a Directive on Credit Servicers, Credit Purchasers and the Recovery of Collateral from 2018) is **to facilitate sales of NPLs among Banks and asset managers while protecting the borrowers**.

The agreed following measures foster the development of an “awakened” professional secondary market for NPLs:

Third party credit purchasers would be able to buy NPLs across the EU. Such credit purchasers are not creating new credit but buying existing NPLs. Therefore, they do not need special authorisation but will only have to comply with borrower protection rules.

Credit servicers, like **ARCIDA ADVISORS GmbH**, are legal persons acting on behalf of credit purchasers and managing rights and obligations under a non-performing credit agreement such as payments collection or renegotiation of terms of the agreement. In order to protect consumers, the European Parliament negotiators made sure that they **would have to obtain authorisation and be subject to supervision by the member states’ competent authorities**. Member states should also ensure that there is a publicly accessible up-to-date list or a national register of all credit servicers.

In general, **the NPL industry has learned from the experience of the first wave of NPLs** in the early 2000's and is now **placing greater emphasis on protecting borrower rights, thereby also avoiding reputational damage to the loan purchaser, its credit servicer and, ultimately, the underlying investors**: The uniform level of protection for borrowers who cannot pay their debts, agreed during the European Parliament negotiations requires credit purchasers and credit servicers to provide accurate information, respect and protect personal information and borrowers’ privacy and refrain from any harassment, coercion or undue influence.

The European Parliament discussions ensured that borrowers should not be worse off following the transfer of their credit agreement. To this end, fees and penalties charged by servicers including transfer costs cannot change nor any additional costs be imposed other than related to the credit agreement.

Finally, the negotiators agreed to take into account a borrower’s individual circumstances such as a mortgage linked to a residential property and ability to repay a loan while deciding on measures. Such measures may include partial refinancing of a credit agreement, modifying the terms of the agreement, extending the terms of the loan, currency conversions, and other ways to facilitate repayment. **Member states may apply measures that work best for borrowers under national regimes but should have an appropriate set of measures at national level**.

Another part of the European Union's NPL Action Plan is the creation of a central electronic data platform at EU level, to which access should be granted not only to national asset management companies, but also – in order to avoid distortions of competition – to private companies.

ii) COVID 19’s impact

The past 18 months have clearly impacted the German market and the effect of the COVID 19 crisis has been felt across all sectors of society having an economic as well as social impact.

How the German economy was hit will only be unravelled in the coming months, as the significant aid programs from both the EU and Federal German Government, as well as the various changes to the legal network have obscured the actual situation for many market participants. The latter includes those engaged within the real estate sector, whether investors, finance providers or indeed tenants. **The COVID 19 crisis has also highlighted, and indeed accelerated, a number of key trends which had been occurring within the real estate sector yet had gone unacknowledged**

from a practical perspective albeit noted on a theoretical basis; i.e. the working environment, changing work patterns, sustainability and digitalisation to name a few. The latter has yet to be fed through into the valuation of underlying debt security, which in the main has not been adjusted or its impact acknowledged.

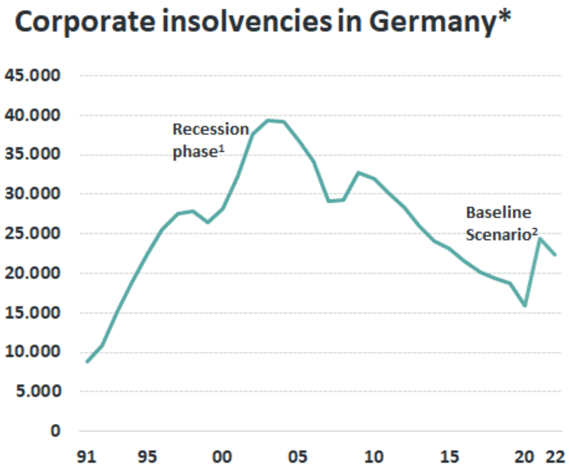
The banking, and wider financing sector, has been particularly impacted and **the COVID 19 period**, which itself has severely challenged operational performance, **has also exacerbated issues already apparent in the sector prior to March 2020, in particular declining balance sheet strength, quality of income as well as existing loan books**. Whilst not triggered by a credit induced boom, there are several features similar to those associated with the post GFC period with credit and illiquidity being a key issue as well as tenant default risk increasing, added to which are the new external regulatory regimes and accounting rules which further complicate the positioning of bank balance sheets and their revitalisation.

For the real estate sector, the acceleration of social & work trends and the increasing demand from tenants, who themselves are being challenged by their employees, is possibly the greatest factor emerging from the COVID 19 period and will have significant influence on the sector. The growth in home office working, the adaptation of work / life balance and the desire of the millennial and Generation X employee will dictate more of the future strategies real estate investors will have to incorporate into their strategies as well as the asset under management.

IV. Realisation

i) Loan Providers’ Challenges – “the calm before the storm”

The current COVID 19 pandemic crisis is challenging the banking system along both known and unknown tracks. Whilst the accumulation of NPLs prior to COVID 19 was indeed reducing and manageable, the impact of the macroeconomic crisis brought about by COVID 19 is providing extraordinary challenges for the system. It **has brought disruption in operations, lending policies as well as balance sheet risk management. Many financial institutions,** already finding the adjustments required under new capital adequacies rules challenging, strategically **were not positioned to deal with the additional complication brought about by COVID 19**. Clearly, they have been helped by extensive government support measures, including loan guarantee schemes, payment holidays, which have resulted in many bank customers surviving in 2020 and into 2021. Regulatory measures were implemented to defer Banks from having to mark loans as problematic when in normal circumstances such a move would have been necessary, which in turn impacted Banks capital and discouraged bank lending. The ECB,



Sources: Sources: Federal Statistical Office and Bundesbank calculations. * The introduction of a new insolvency law in 1999 and its amendment at the end of 2001 limits statistical comparability with previous years. 1 Until 2017, based on recession dating of the German Council of Economic Experts and thereafter on Bundesbank assumptions. See also German Council of Economic Experts (2017), Annual Report 2017/18. 2 Building on the actual figures from Q1 2020, the scenario begins in Q2 and is based on the Bundesbank's June 2020 forecasts of real economic developments; see Deutsche Bundesbank (2020), Monthly Report, June 2020, pp. 26 ff. The temporary suspension of the obligation to file for insolvency from March 2020 as a result of the coronavirus pandemic has not been taken into account.

and national central Banks adjusted to this by providing significant liquidity into the financial system.

Though many businesses suffered, the number of defaults dropped compared to a year earlier. Indeed, bankruptcies stabilised at a rate some 15 to 30% below the “normal” just before COVID 19 in Germany over the period. Suggesting that **the support packages helped businesses getting through the crisis yet keeping alive a number of “zombie firms”**.

With the impending relaxation of ECB & government support measures, and the increasing awareness of the declining strength of certain Banks’s balance sheets, **it is expected that there will be an increase in NPLs for Banks in coming years.** *(see graph page 2)* For the Banks the impact will be felt in several ways within their loan books, on a sectoral basis, client size as well as existing legacy positions.

As seen in the “real market”, **there has been a distinct impact to certain business sectors** and these clearly will continue to be vulnerable to the economic disturbances created by the pandemic response, albeit such sectors are impacted in different stages of the cycle meaning that the unwinding of poor performing loans will take time. Here **real estate and construction may lag the most** e.g. initially running construction projects will have to be finished; whilst rents continue to be paid as tenants survive on government support. As the support is withdrawn, tenant default is expected to increase, added to which is a structural shift of working patterns which reduces office space demand, with on-line retail continuing to take an increasing proportion of sales from the high street.

Regarding Bank’s client pool, it is expected that the small and medium-sized enterprises (“**SMEs**”) will have been the most impacted by the pandemic operationally as well as with the changing structural shifts within the economy, and hence will find it harder to recover. This is a client pool, where **the German Banks** are most exposed and **will undoubtedly require intense operational resource (which the Bank’s do not have) to assist manage loan exposure** to such clients.

Added to the above, and a factor concerning regulators prior to the onset of the pandemic was the ability of Banks to absorb NPLs and the size of under provisioning as a share of bank capital. This concern has only been exacerbated by the COVID 19 crisis.

Taking the three indicators outlined above and being aware that additional variables play into the development of NPLs, it is a challenging time for Banks as well as regulators in preparing to manage the impending growth in NPLs.

However, **support measures are not forever (for example, 60% of the government-guaranteed loans granted in connection with the pandemic (totalling approximately EUR 67 billion) will reach maturity prior to 2024, according to Roland Berger market research)) and with their eventual withdrawal Banks will have to face the prospect of a sharp increase in impaired loans as well as NPLs**. Such recognition tends to be prolonged by Banks in an effort to delay recognition in their profit and loss statement, and to conceal the loss of capital. This behaviour may lead to continued financing of non-viable firms and delay restructuring effort at the firm level with negative consequences for growth. These issues are further exacerbated, and more desirable measures such as internal workouts or the transition to more market-based solution are prevented, if forbearance measures are retained for too long.

Compounding the economic and regulatory challenges faced by the financing community, is the issue of having the requisite in-house expertise and experienced staff to manage such problematic loans. Having managed the NPL workouts post the GFC, the banking community reduced and/or closed most of their specialised workout teams resulting in the disbursement of knowledge & requisite skill meaning that they are today adrift and lacking key competences to effectively take operational control. Similarly, where the finance community in the past became reliant on third party serving capability, that itself has also (almost) disappeared as the market for NPLs reduced.

ii) Impact on German real estate market

The outbreak of COVID 19 rapidly spread across the German real estate markets and has taken market participants by surprise. There has been, and is currently, a large amount of information and misinformation emerging on a daily basis as well as numerous theoretical speculations as to the likely impact. Hence, implication as to its effect on the real estate sector cannot be precisely quantified as of today; but it is generally agreed that via NPLs, as well as on a direct investment basis, opportunities to create value in the real estate market(s) are likely to emerge across all sectors.

The exceptional circumstances have impacted each sector of the real estate industry in different ways, as well as exacerbated the risk spread across the yield curve. The latter yet to be fully appreciated due to the weight of capital in the market. While hospitality and retail submarkets have seen the sharpest decline on operating performance, residential and office (which are less sensitive to contractual and operating income) are expected to be the more resilient. Market players suffering from liquidity shortage resulting from rent arrears combined with undiversified leasing structures will lead to an increased supply of product on the investment market of assets requiring repositioning and/or recapitalization.

Office

Following a record year in 2019, office markets showed significant drop in take-up. In general, the markets remain relatively stable; including rents, and the increase in vacancy remained moderate assisted by the Government support measures. With the unwinding of tenant support measures; it is expected that owners vulnerable with high exposure to short-term leases will become under pressure to find solutions or lose control of their asset which will lead to new activity on the transactional market. Added to which, the impact and changing working practices, which have been accelerated by COVID 19, will necessitate to owners to deploy new strategies with regard to retain let alone enhance values – here entrepreneur skill set will need to be employed.

The above is compounded, as employees will increasingly have the choice of remote working creating the dilemma (for asset owners) as to the use of existing physical office allocation with non-analog relevant tasks also not necessitating actual workplace. The challenge consists in the development of agile workplace combining on-site and remote offices and facilitate a quick response to changing requirements.

Retail

Retail spaces has been so far one of the most impacted segments in the real estate industry triggering an ongoing process of change in a sector of economy that was already facing challenges prior to the outbreak of COVID 19.

Retailers were challenged to preserve cash during mandatory closure following lockdown measures while facing fixed costs burden which was a key facilitator behind the government financial support.

Following the term of the German insolvency filling suspension it is expected a higher default quote of tenants as delayed response of the pandemic.

It is also expected that rental agreements in the sector will be further impacted and their structure changed to include such matters as: pandemic clauses, growth in turn-over rentals, shorter lease term.

Furthermore, many retailers will rethink their operations and supply chains by integrating E-Commerce as further pillar for sustainable performance. As the structural change in the retail market accelerates, focus will be placed on the shift toward a flexible omni-channel retail model and sustainable fulfilment.

Opportunities will arise in repositioning in particular properties with large surface areas in city center locations. Falling rents and the threat of vacancies are upping the pressure to become proactive through engaging in usage alternatives and mixed usage. Innovative new concepts or formerly pure E-tailers might break into the market with fully automated services making online ordered products available for collection 24/7.

Logistic

As a consequence of the negative impact on the retail industry, the logistic segment has taken advantage of the breakthrough of E-commerce. Re-shoring or near sourcing of manufacturing and increase of diversification in terms of sourcing in order to accelerate and stabilise supply chains will result to a densification of regional demand for logistic and industrial facilities. Also increase of online grocery shopping for new cohort people could catalyze the sector.

The accelerated post COVID 19 expansion of online grocery and omni-channel retailing will boost the demand in urban logistic units and challenge the investors to find solution within the urban environment to fulfill the new requirements

The growing demand in the logistic sector is symbolized by falling vacancy rates as well as yield compression. Prime rents are expected to rise. From an investment perspective, strategic acquisition of large green field areas in A as well as B locations that are currently not used for logistic purpose are to be anticipated.

Hospitality

The hospitality industry took a harder hit than any other sector. International travel around the world suddenly stopped, quarantine measures as well as prohibition on hosting tourists immediately impacted occupancy rates to levels never observed before. The upcoming challenge for the operator is to generate sufficient cash flow to cover pre-crisis high rental levels and ultimately put pressure on the operator – landlord relationship, forcing them to find solutions by flattening or deferring rental obligations. Weak operators are expected to turn in default of payment and subsequently insolvency, unblocking opportunities for repurposing hotel projects in alternative type of usage. Such situations are now seen in Germany.

Residential

The residential sector is widely considered as the most resilient sector to the impact from COVID 19 and more generally to economic shocks with stable long-term income profile. Potential post COVID 19 side effects risks to be considered toward low-income rental properties with tenants exposed to structural unemployment impact. These categories of households are more dependent on government support.

Potential inflation risk and consequently rising interest rates for some highly indebted households (debt ratio for private households kept increasing in the last year) with overvalued assets may be vulnerable to insolvencies and foreclosures.

Developments

Resource prices and delay in availability are increasing significantly, which is compounded by the structure of development financing with repayment due at completion. There is a clearly perceived vulnerability from Banks toward price correction in the development segment and this is to be expected to occur in the near future.

Developers that have secured project land plots requiring significant up-front payments, face greater uncertainty as investors which are less willing to be engaged in forward deals. Added to which financing conditions for development project has also become more restrictive. Banks request higher risk margins. Several Banks even pull out of the development market. Developers are needing to look for much higher alternative financing solutions or risk losing control of their developments.

V. Solutions

Solutions must be defined within the context of the changing financial, regulatory as well as real estate landscape within Germany, and it is clear that there is a requirement to look at matters from a fresh perspective. The latter needs to be considered by creating a wider partnership involving all relevant stakeholders both at the debt level as well as underlying real estate. New thinking and challenging historical conventions will have to be the norm, more so with the arrival of ESG principles having such a fundamental impact on the way business is today and, in the future, to be undertaken. Already risk managers within several of the largest banks are active seeking creative solutions to their underlying positions and seeking out partners who are able to facilitate and execute such strategies.

i) Management Platform & Partnerships

As indicated under Realisation, the capabilities, as well as capacities, of many Banks are at best limited in the NPL arena, and resource management has become a strategic as well as pressing issue requiring to be addressed. Whilst several of the larger financial institutions may well be able to re-allocate resources to cope with the expectant increase of NPLs from within their loan book, this will not be the case for the majority of lenders. Hence the establishment of partnerships between financial institutions and private specialised asset management platforms is seen as a necessity as well as economic sensible option. Such partnerships are under discussion today. This allocation of roles is also part of the rationale behind the EBA’s initiative in formalising and regularising the NPL secondary market as discussed above.

A challenge also sits within the asset management sphere, where there are few NPL professionals let alone specialised teams in existence today who have the required German market experience and knowledge both on the NPL servicing, as well as with the capacity to manage the underlying real estate security to extract value. The proposed new rating for such platforms and their oversight by Federal bodies also means that credentials and capabilities will be held to scrutiny prior to a rating to be given, which will restrict numbers applying.

Where found, such professional workout capacity is efficient but also avoids reputational damage for all parties involved whether borrower, NPL seller, or acquisition finance lender.

Partnerships can be formed, not only with the financial institution but also with the NPL borrowers ("*fresh money aspect*"), the acquisition finance lenders and the communities in which the collateral properties are located ("*fresh money leads to sustainable properties and communities*").

ii) Sector & Asset orientation

Realistic assessment of the future opportunity of the German real estate market (post COVID 19); in particular, third-party usability of defined asset classes e.g. hotel, retail and second tier office properties will have to be a pre-requisite for any solution. Here, mindset, capability and track record of partners need to be assessed and value given to those who have or are addressing the emergent trends within the sector.

iii) ESG considerations necessity in solutions

ESG means a shift toward sustainability for society and the economy in general, but for the financial industry in particular. This, therefore, also and especially applies to investors in financial products.

Products, in other words, that were previously judged and selected exclusively on the basis of their economic success, namely the best possible figures. The success of a financial product was measurable by the maximum profit it could and did achieve. In the recent past, this has changed. The principle of sustainability divided into the three ESG evaluation categories (environment, social, governance) also found its way into the world of investors.

This increased importance of ESG relevance for investors was also reflected in the development of the Principles of Responsible Investments (PRI) network in 2006. In the meantime, the majority of (German) institutional investors take sustainability criteria into account when investing; this is particularly prevalent for capital management companies (*Kapitalverwaltungsgesellschaften*) (91 percent), foundations and churches (88 percent) and insurance companies (70 percent) (as of 2018).

The Taxonomy Directive and the Disclosure Directive of the EU also impose a legislative obligation on the financial market to report on the sustainability of financial products. Even NPLs as an investment cannot evade this.

Many of the end investors funnelling money into ESG strategies are happy with safe, uncontroversial assets. They do not want to play in deep, dark waters, such as distressed debt, long/short credit or structured credit.

NPLs therefore do not necessarily appear to be a suitable fit for an ESG investment strategy at first glance, but they are at second glance. In fact, if the realisation is done correctly, NPLs can be a perfect asset from an ESG point of view. If the realisation of NPLs is no longer judged and operated according to the guiding principle of maximizing profits as quickly as possible - which has often and repeatedly led to the harshest workout strategies towards the borrowers - then NPLs can fulfil all three relevant sustainability criteria:

- Environment: The realisation of NPLs secured by real estate can also be an expression of sustainability. It offers the opportunity to "produce" a functioning property from a distressed existing property by preserving the substance (keyword "*grey energy*") and the economical use of new resources and by exploiting new technologies, which can then be positioned profitably on the market.

- Social: The social aspect of sustainability can also be considered and implemented in the best possible way during the realisation of NPLs: On the one hand, this can consist in the choice of a strategy for dealing with borrowers, which should initially focus on cooperation with the borrower. One can thereby rely on instruments, such as debt waivers, in order not to impede an economic and possible new start for the borrower, if he cooperates at the same time in the disposal of the collateral. On the other hand, the realisation, which is done by means of an ESG-compliant upgrade and repositioning of the property, should be carried out using regional resources, be it local Banks, be it local contractors and craftsmen. In contrast to earlier processing strategies, which were driven by numbers and focused only on speed, regional politics and civil society should be involved in the repositioning process in order to make it sustainable in the long term.

- Governance: Particularly in the case of a product such as NPLs and their realisation, corporate management must ensure even stronger self-commitment to compliance with legal requirements when dealing with borrowers. After all, the entire economic existence of borrowers is often affected. In case of doubt, the realisation process should therefore be structured in such a way that cooperation with the borrower is given priority and compulsory enforcement is only given secondary priority. Appropriate reporting to investors on the liquidation strategies will have to be taken for granted.

VI. SUMMARY

As shown in this paper, the market for NPLs has expanded, and will continue to grow further, and access, together with liquidity, is being addressed by the key market regulators, with the ECB and the European Commission taking the lead. Clear opportunities are emerging for the investment community to join with the banking / lending providers to expand this market, as a result it should be considered as part of an alternative asset allocation for it brings diversification as well as the opportunity to leverage real value both indirectly and directly regarding the underlying security. The key to maximising value in this asset class is through partnership, with the latter having the appropriate focus and management expertise.

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