

The Deloitte logo is positioned in the top left corner of the page. It consists of the word "Deloitte" in a white, sans-serif font, followed by a small yellow dot. The background of the entire page is a blurred city street at night, with warm yellow and orange bokeh lights from street lamps and buildings, and a prominent blue bokeh light on the left side. In the bottom right corner, a portion of a digital display is visible, showing a blue line graph with several peaks and valleys, representing market data.

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**European Banking & Loan Portfolio
Outlook - Market Update**

A changing environment

Q2 2023

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Financial Institutions Group in Europe

Portfolio Lead Advisory Services



ALOK GAHOTRA
Partner
United Kingdom
Tel : +44 2070072164
Email : agahotra@deloitte.co.uk



ARUN SHARMA
Partner
United Kingdom
Tel : +44 20 7303 2551
Email : arunxsharma@deloitte.co.uk



BALAZS BIRO
Partner
Central & Eastern Europe
Tel : +36 14286865
Email : bbiro@deloittece.com



GEORGE MARTIDES
Partner
Cyprus
Tel : +35 725868604
Email : gmartides@deloitte.com



HRISA NACEA
Partner
France
Tel : +33 155614195
Email : hnacea@deloitte.fr



NILS-ALEXANDER BERENT
Partner
Germany
Tel : +49 69756956929
Email : nberent@deloitte.de



THOMAS MAZUR
Partner
Germany
Tel : +49 40320804582
Email : thmazur@deloitte.de



JOSE ANTONIO OLAVARRIETA
Partner
Spain
Tel : +34 914432875
Email : jolavarrieta@deloitte.es



PANAYIOTIS CHORMOVITIS
Partner
Greece
Tel : +30 2106781316
Email : pchormovitis@deloitte.gr



ELEFThERIA KYRIAKOPOULOU
Partner
Greece
Tel : +30 2106781332
Email : ekyriakopoulou@deloitte.gr



MARTIN REILLY
Partner
Ireland
Tel : +35 314172212
Email : mreilly@deloitte.ie



UMBERTO RORAI
Partner
Italy
Tel : +39 0283325056
Email : urorai@deloitte.it



SUSANA BENTO
Partner
Portugal
Tel : +351 210422522
Email : sbento@deloitte.pt



SIEBE GROENVELD
Partner
The Netherlands
Tel : +31 882888154
Email : sgroenveld@deloitte.nl

Strategic Advisory and M&A



JONATHAN GOLD
Managing Partner
United Kingdom
Tel : +44 20 7007 7966
Email : jgold@deloitte.co.uk



ANGELINA KUZNETSOVA
Partner
United Kingdom
Tel : +44 20 7007 4689
Email : akuznetsova@deloitte.co.uk



DANIEL OHANA
Partner
United Kingdom
Tel : +44 20 7007 3029
Email : dohana@deloitte.co.uk



GUY STEVENS
Partner
United Kingdom
Tel : +44 20 7303 7611
Email : guystevens@deloitte.co.uk



DAVID LOCK
Senior Director
United Kingdom
Tel : +44 20 7007 0341
Email : davidlock@deloitte.co.uk

Recovery & Resolution Advisory Services



ALASTAIR MORLEY
Partner
United Kingdom
Tel : +44 20 7303 4785
Email : almorley@deloitte.co.uk



ALEX BROWN
Partner
United Kingdom
Tel : +44 20 7303 0983
Email : albrown@deloitte.co.uk



ANDREW GRACIE
Senior Advisor
United Kingdom
Email : agracie@deloitte.co.uk



RICHARD BEVAN
Senior Director
United Kingdom
Tel : +44 20 7007 2503
Email : rbevan@deloitte.co.uk

About this report

Unless specified otherwise, all transaction data in this document is based on ongoing tracking and monitoring of deal activity, based on Deloitte practitioners' insights into the respective markets together with public and industry sources, including Debtwire and is as at December 2022. Similarly, where included, details of ongoing transactions are as at end 4Q22 (unless otherwise stated). This combination of sources limits the detail we can provide on individual transactions or identifiable data segmentation.

For EU NPL data (unless otherwise stated) we use the European Banking Agency ("EBA") which may lead to some differences compared to other sources. GDP and inflation data is largely drawn from the Economist Intelligence Unit ("EIU") again, unless otherwise stated.

Introduction

The past 18 months have delivered a paradigm shift in European banking and loan portfolio markets.

Higher interest rates, a hiking cycle which began in early 2022, have (at least up until now) boosted bank earnings and profitability.

For the first time since the Global Financial Crisis ("GFC") and European Sovereign Crisis, net profit after tax for the major listed banks in Europe was over €130bn – the highest level of profit since 2006, driven by a large increase in net interest income and associated Net Interest Margin ("NIM"). Meanwhile impairments swung from negative during the COVID 2020 period, to writebacks in 2021 (and in some cases 2022).

However, despite this better operating environment for banks, mean valuations for the listed sector remain weak (trading at 0.7x book value at time of writing). Investors remain wary of a sector that is inherently linked to the economic cycle, subject to regulatory change, and recently accident prone (see below). Higher interest rates can be a double-edged sword if they increase the risk of borrower default and adversely affect asset quality, with the Bank of England's ("BoE") 1Q23 Credit Conditions Survey¹, published in April 2023, providing an example early indication that lenders on balance expect default rates to increase during 2Q23.

Recent market turbulence has complicated matters

Although unrelated to asset quality, global banking markets have been tested since March driven principally by events in the US and Europe.

- Silicon Valley Bank's ("SVB") influx of deposits during the COVID period, and subsequent search for low-credit risk yield turned sour as interest rates increased in 2022 leaving them with significant unrealised losses on US government debt instruments which fell in value as rates rose. As deposit balances began to fall, and depositors searched for better yield, so these unrealised

losses became crystallised, in turn eroding investor confidence and leading to a run on the bank in which billions of dollars were withdrawn in the space of 48 hours.

- What started with SVB spread first to Signature Bank, as depositors took fright - Signature had high amounts of uninsured deposits - and then at the end of April to the much larger First Republic whose share price had been under pressure since events at SVB first unfolded.
- For Credit Suisse ("CS"), given its issues and challenges and amidst a febrile market, the situation could only be resolved by regulatory action and a sale to UBS. Though their causes were very different, as with SVB and the other US regional banks mentioned above, CS's destiny was hastened by a loss of market confidence in the institution, leading to significant deposit and funding outflows.

The hiatus has left banks, regulators and policy makers with work to do, including how to manage liquidity in a digital age when cash can be moved instantaneously, the importance of sound corporate governance and risk management, the sufficiency of deposit guarantee limits, as well as recovery planning and resolution preparedness.

Macro-economic environment is more muted

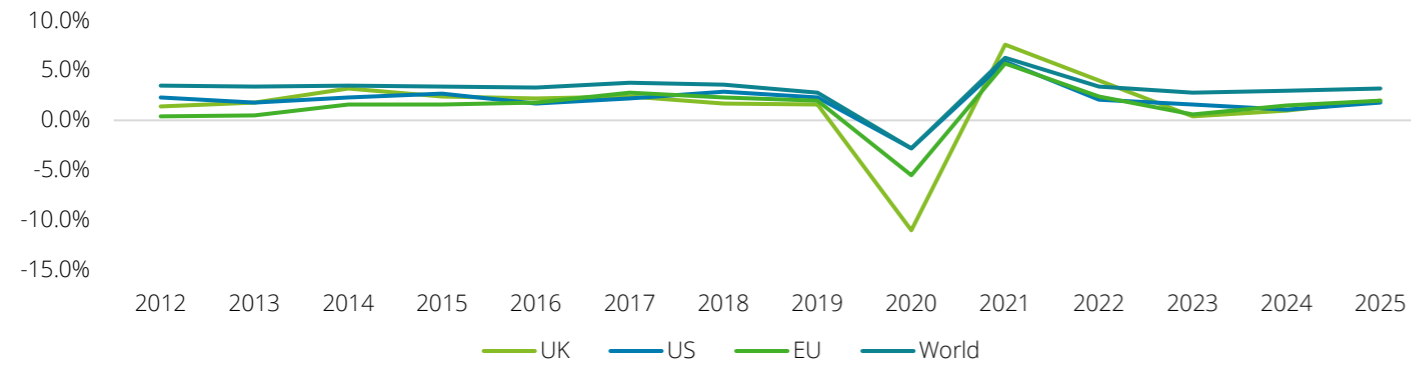
Latest macroeconomic forecasts point to a challenging few years ahead, with the International Monetary Fund ("IMF") predicting global economic growth to dip below 3% in real terms in 2023 and to remain at around 3% for the next five years. This is the organisation's lowest medium-term growth forecast since 1990, and well below the average growth of 3.8% seen in the past two decades. Of course, these are averages and prospects in some developed countries including the US, EU and the UK, are even more subdued.

¹ Credit Conditions Survey - 2023 Q1 | Bank of England

The banking sector and loan portfolio markets are, of course, not immune to global events. The higher interest rate environment which has benefitted some is a symptom of high inflation which has been a feature of most economies for the last 12 months - an aftereffect of the pandemic as pent-up demand was released, and supply side shortages came to the fore as well as ongoing geopolitical tensions.

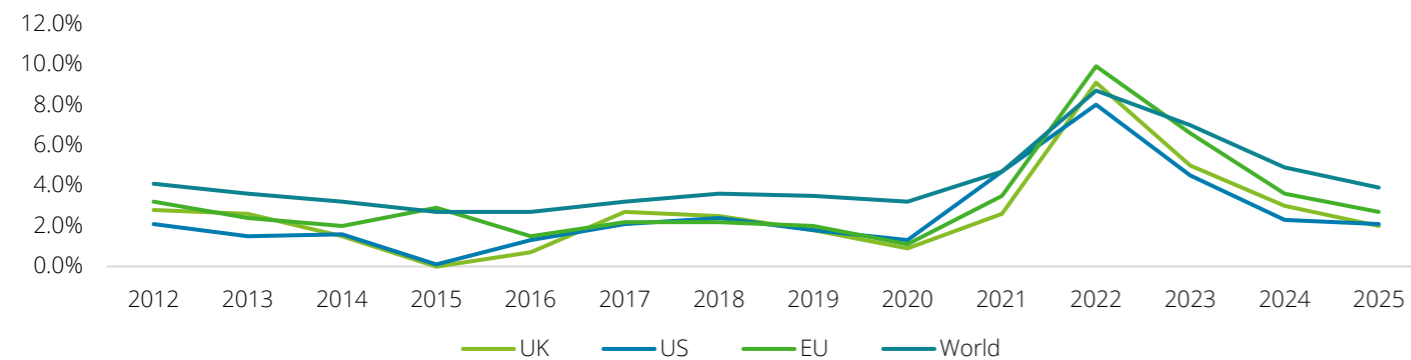
That said, inflation is forecast to fall rapidly in 2023, albeit (in some jurisdictions) not as quickly as initially anticipated, with wholesale energy prices and other supply side/ logistics pressures having eased significantly and inventories rebuilt since the pandemic. Markets are pricing for interest rates to continue to rise in the UK and Europe, but current expectations are that the US rate cycle has now peaked - with markets pricing rate cuts by the end of the year.

Figure 1: Real terms GDP growth (actual and forecast)



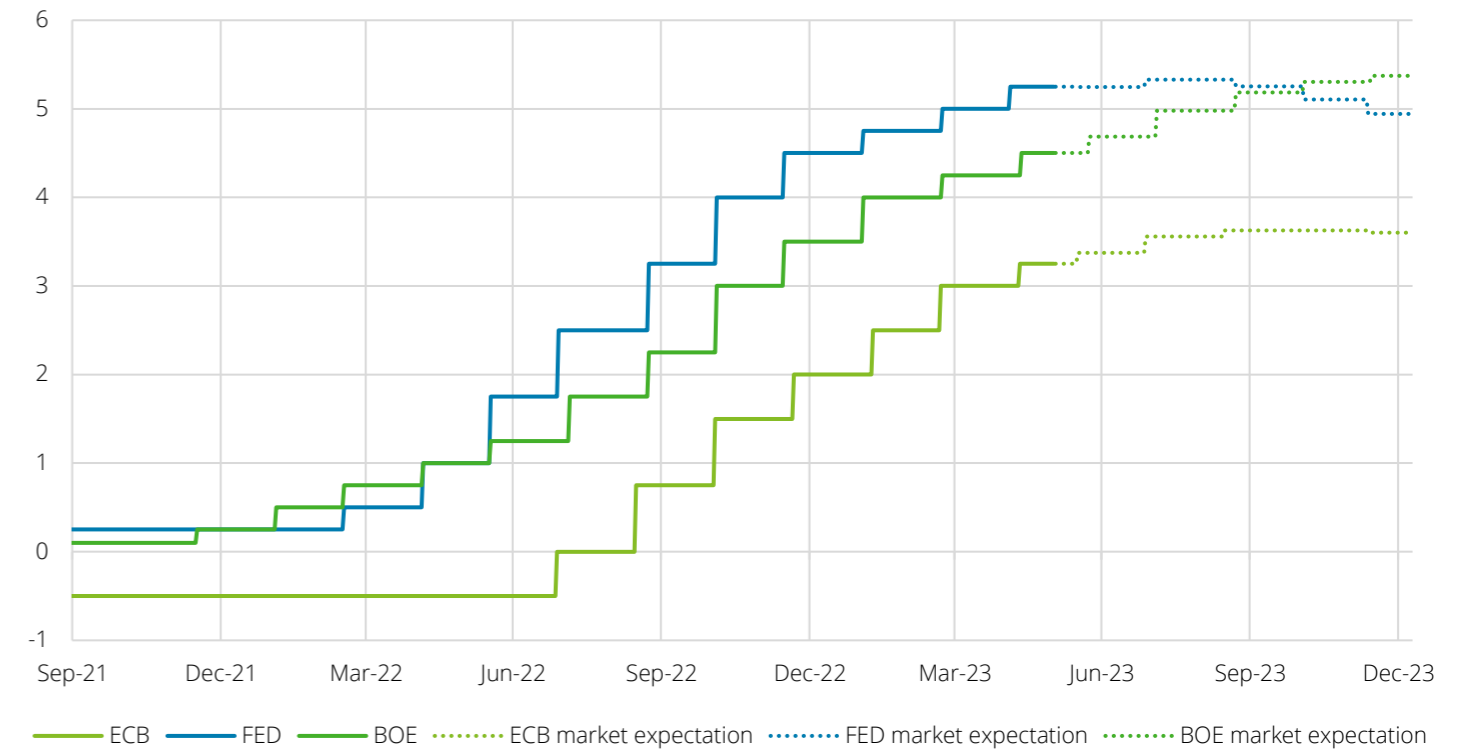
Source: IMF as at April 2023 (for the UK we show the most recent data released by IMF on 23 May)

Figure 2: Inflation (actual and forecast)



Source: IMF as at April 2023 (for the UK we show the most recent data released by IMF on 23 May)

Figure 3: Interest rate decision history - and market expectations until end of 2023 for ECB, FED and BOE (as at 31 May 2023)



Source: Refinitiv

The above topics are explored further in this document, which we hope you enjoy reading and find useful. Please do not hesitate to contact one of the team if you want to discuss any of the matters addressed in this short report further.

Executive Summary

Recent Bank performance in context

We look at the long-run performance of the European banking sector including profitability and how other key performance indicators (“KPI”) have compared with recent history.

In raw KPI terms, the banking sector is currently enjoying its strongest period of performance for many years: profits are up, margins are higher, capital is solid and close to highs, non-performing exposures have continued to fall over recent quarters, liquidity – at aggregate levels at least – remains solid, and capital returns (via dividends and buybacks) are improving. Analyst consensus expectations are for earnings and returns to improve further in 2023-24.

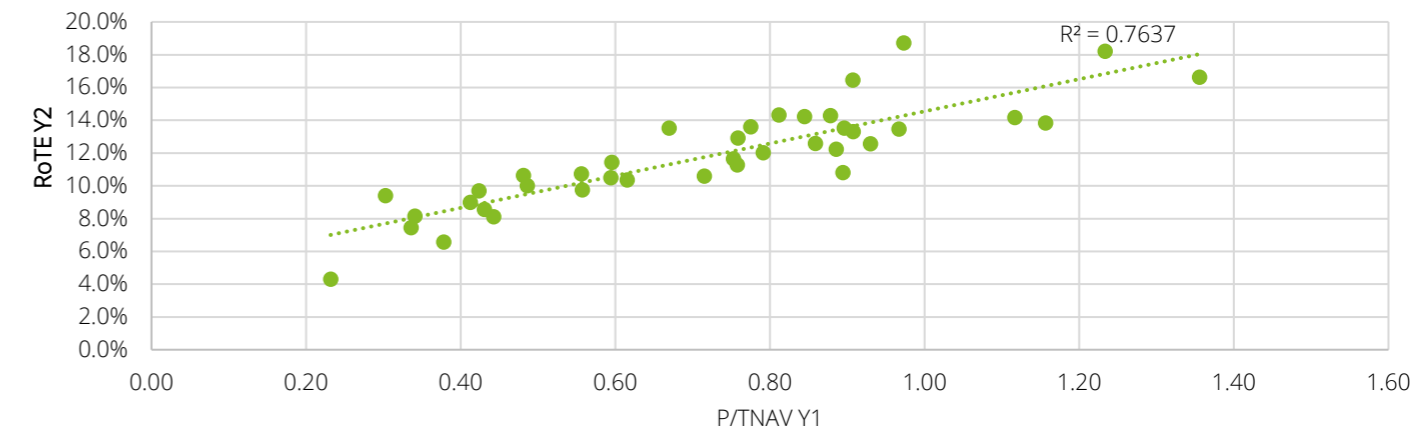
Importantly, there are key differences in interest rate sensitivities and market structures within Europe – some geographies have benefited from rate rises far faster than others.

Bank valuations, outlook and key themes for next 12 months

We explore the valuation of the European bank sector in context, and discuss the key themes and outlook in more detail.

Despite the stronger 2022 profitability and market consensus outlook, bank valuations remain undeniably weak. Price / Book ratios for the sector are below book value (as they have been for much of the last decade), and the implied cost of equity for the sector is around >14% - well above the long run average of around 10% over the last 23 years. This reflects market uncertainty and nervousness on the outlook, sustainability and quality of bank earnings – as well as unforeseen costs and risks which have a tendency too often to tarnish the banking sector (seemingly) without warning.

Figure 4: European Banks’ Valuation Regression (as at 31 May 2023)



Source: Refinitiv data, Deloitte analysis



Key themes for the next twelve months include:

- Interest rate expectations, and the potential impact on bank Net Interest Income (“NII”) momentum amidst generally weaker loan demand.
- Funding costs are likely to rise, given the interest rate cycle, and upcoming repayment of COVID-era central bank facilities and MREL issuance needs.
- Asset quality so far so good, but we anticipate heavy market focus on asset classes such as US CRE, given recent US regional bank challenges.
- Cost inflation is likely to persist, given bank reliance on IT and human capital.
- Bank M&A activity is likely to continue as a route to drive bottom and top line growth, as well as improving capabilities to attract and retain customers. We expect activity across business combinations (long-discussed, but now potentially with a catalyst), performing loan portfolios (taking advantage of funding cost differences, non-core divestments), NPLs, platforms in market adjacencies (e.g. wealth, specialist lending), partnerships (e.g. between banks and non-banks, between balance sheet and non-balance sheet businesses).
- Disruption from new market entrants such as international banks, Fintechs or BigTech.

We expect M&A activity to pick up during 2H23 and into 2024.

Implications of recent market stresses for regulation

Following the events of recent months in both the US and Europe we provide an overview of where supervisory priorities may lie (and implications for the banking sector) in the near, medium and long-term.

- **Near-term:** focus will be on how well banks are set up to identify and react to liquidity vulnerabilities; are banks doing enough to

manage interest rate risk in the banking book; are supervisors and banks comfortable with the treatment of assets held at amortised cost; and what are the implications of recent events for the AT1 market.

- **Medium-term:** we expect supervisors to redouble their efforts in relation to recovery plans, particularly for banks with structural vulnerabilities in their business models; and they may face calls to push for stronger regulatory standards, particularly for liquidity. In the UK, we could see the PRA revisit aspects of its proposed Simpler Regime for smaller banks and, in the EU, a tougher stance on third-country branches (“TCBs”).
- **Long-term:** questions for Global, UK and EU regulators will revolve around the effectiveness of the resolution regime, especially as it applies to G-SIBs and D-SIBs, the balance between going and gone concern capital and liquidity, the G-SIB and D-SIB frameworks and the role of deposit insurance. In the UK, HMT will think carefully about its position on ring-fencing.

Basel 3.1 & Climate Risk implementation

We review the implementation timeline for Basel 3.1, which has implications for how much capital banks must hold against certain assets. We also provide an update on climate risk, an increasing area of focus for policy makers and regulators within Europe.

Loan portfolio transaction activity and outlook by market

We summarise loan portfolio transaction activity in the last 12 months, and the outlook for loan sales by individual market within Europe.

At its peak, European banks were holding on their balance sheets more than €1 trillion² of non-performing loans (“NPLs”) with a similar level of non-core loan assets. Today, the volume of NPLs has reduced significantly and as at 4Q22 stood at less than €500bn (considering NPLs only), with institutional investors acting as a

² Breugel

key beneficiary of wholesale loan portfolio divestment strategies employed by lenders and state-owned institutions across the continent.

The percentage of loans classified as IFRS9 Stage 3 (“Stage 3”) continued its overall downward trend from 3.6% in 1Q19 to 2.1% in 4Q22. While the share of IFRS9 Stage 2 (“Stage 2”) loans decreased slightly to 9.4% in 4Q22 from 9.6% for 3Q22, levels remain elevated compared to 2019 (7.2% as at 1Q19), hinting at ongoing vulnerabilities which could translate into higher NPLs in the future particularly if ongoing challenging macroeconomic conditions persist for any significant period of time.

Deal flow, which had recovered in 2021 as COVID lockdowns were eased and markets re-opened (~€118bn traded), fell back again in 2022, with €63.4bn traded in the year (and €27.9bn ongoing as at 4Q22), through a combination of resilient asset quality and as higher interest rates and macroeconomic uncertainty dampened investor appetite.

We expect transaction activity to pick up during 2H23 and into 2024 as banks and borrowers adjust to the higher interest rate environment. The knock on implications for European markets from US CRE pressures (where banks are reported to be looking to sell exposures) remains to be seen, but could lead to additional activity.

High levels of historical portfolio sales in the primary market over the last 5+ years are likely to see a significant ripple effect in the secondary market, as debt funds come to the end of their harvest periods and look to unload rump exposures which have not yet been fully worked out.

- **UK:** The percentage of loans classified as Stage 3 has remained low over the past few years, decreasing to 1.7% by 4Q22³. There has been an uptick in the volume of Stage 2 assets; despite little change in observed credit performance, downgrades in HPI

³ Deloitte IFRS 9 | 4Q22 results update

expectations have led to worsened future default expectations, pushing more loans over the ‘significant increase in credit risk’ probability of default (“PD”) thresholds and into Stage 2, reaching 12% as at 4Q22 vs 11% as at 3Q22⁴. Recent transaction activity has been focused on performing assets. As new NPLs accumulate, banks may seek to periodically off load, high volume, smaller ticket SME NPL portfolios (including Coronavirus Business Interruption Support Loan Scheme (“CBILS”) portfolios where these fall into default).

- **Ireland:** Considering its NPL ratio was the third highest in Europe in 2014, Ireland has made extraordinary progress in the past 8 years to bring this back under control. NPL volumes in Ireland continued their downward trend with the percentage of loans classified as Stage 3 reducing from 5.4% as at 4Q20 (COVID peak level) to 2.8% as at 4Q22, primarily driven by a resumption of banks’ NPE reduction programmes, along with government sponsored financial support measures and loan moratoria which slowed the creation of new NPLs during the pandemic. In absolute terms stocks of Stage 3 loans at Irish Banks at 4Q22 were €8.2bn compared to €8.0bn⁵ as at 4Q19 (immediate pre-pandemic low). Two international banks chose to exit the Irish market during 2021/22, which has led to concentration of loan exposure in the three remaining domestic banks.
- **Spain:** Loans classified as Stage 3 held by Spanish banks totalled ~€80.3bn as at 4Q22, second to France (~€137bn) and ~19% of total EU stocks. Moreover, Spanish banks have seen an increase in the level of Stage 2 exposures from 5.8% (€141bn) as at 4Q19 to 6.8% (€186bn) as at 4Q22. Overall deal activity in 2022 was €6.5bn, three quarters the level observed in 2021. Higher interest rates have widened price expectations, particularly in terms of residential mortgage trades. As such and while the present

⁴ Deloitte IFRS 9 | 4Q22 results update

⁵ EBA

uncertain economic outlook may dampen transaction activity in 1H23, regulatory pressure, and the need to proactively manage RWAs could be the catalyst for increased market activity in 2H23.

- **Portugal:**

During 2022, the main Portuguese banks continued to drive their deleveraging agendas, with ~€1.8bn of portfolio sales transacted in the year (and a further ~€400m ongoing at the year-end) albeit this remains well below pre-pandemic levels. Investor appetite for NPLs remains strong. However, some transactions were not concluded amid more challenging economic conditions in 2022.

- **Italy:**

Italy regained its spot as the most active market, both in terms of volumes (~€30bn traded) and number of deals (29 transactions (39 in 2021)) and is anticipated to remain relatively busy notwithstanding legacy stocks of NPLs have been substantially worked through. The Italian government's GACS or "Garanzia sulla cartolarizzazione delle sofferenze", introduced in 2016 to provide state backed guarantees for qualifying NPE portfolios, has proved transformational in helping banks manage down their stocks of defaulted loans. GACS expired on June 14 2022, with discussions ongoing between Italy and the EU around its' renewal.

- **Greece:**

The volume of credit impaired (Stage 3) loans held by the four main Greek banks totalled ~€12bn (primarily corporate loan exposures) as at 4Q22 (5.4% Stage 3), compared to ~€18bn as at 4Q21. The level of loans marked as Stage 2 remains elevated, 11.4% as at 4Q22 compared to 12.5% in 2019 and higher than the EU average of 9.4%. As legacy NPL stocks reduce, Greek banks have moved to synthetic securitizations of performing loan portfolios to further reduce RWA's and drive capital ratio improvement. Greek banks are also looking to divest REO portfolios onboarded from seized collaterals.

- **France:**

The level of loans marked as Stage 3 by French banks, which includes exposures abroad, totalled ~€137bn as at 4Q22, virtually unchanged since 4Q21 (~€139bn), representing by far the largest balance in Europe. At the same time, French banks are sitting on sizeable stocks of Stage 2 loans, which increased significantly during the pandemic from €324bn as at 4Q19 to €631bn as at 3Q22 – 4Q22 was €590bn. It remains to be seen whether regulatory pressure to proactively manage NPLs will see increased transaction activity.

- **Germany:**

Loan portfolio transaction activity recovered in 2022, albeit volumes sold were still well below pre-pandemic levels and dominated by two major disposals of shipping portfolios from hsh portfoliomanagement AöR. The percentage of loans classified as Stage 3 fell from 1.4% as at 4Q19 to 1.3% in 4Q22, reflecting successful business support measures which have slowed new NPL generation. Loans marked as Stage 2 increased from 8.4% as at 2Q21 to 9.9% as 4Q22.

- **Central & Eastern Europe:**

Despite the current turbulent market environment, the NPL ratio continued its downward trajectory reaching 2.9% on average across CEE at the end of 2022⁶. Overall NPL stocks have also gradually decreased to €31.6bn at the end of 4Q22 (€38.7bn in 2019)⁷, albeit unevenly across the region, with some countries seeing an increase in NPL levels, with the ongoing conflict in Ukraine not yet having a material negative impact on the default rate. EU sanctions related regulatory action has resulted in some limited portfolio transaction activity.

⁶ Deloitte analysis of National Bank's data includes banks not monitored by the EBA and institutions based in non-EU countries.

⁷ for Lithuania and Slovenia we use 3Q22 and for Serbia 2Q22 as the most recent data available.

1Q23 completed deals

1Q23 saw ~€6bn of deals completed, comprising UK (~€1.3bn), Italy (~€1.2bn), Greece (~€1.1bn), Cyprus (~€0.8bn), Spain (~€0.7bn), Sweden (~€0.7bn) and Portugal (~€0.2bn). Further details of deals after the cut-off date for this publication can be found in our interactive dashboard - to subscribe email DelevEuropeDashboard@deloitte.co.uk.



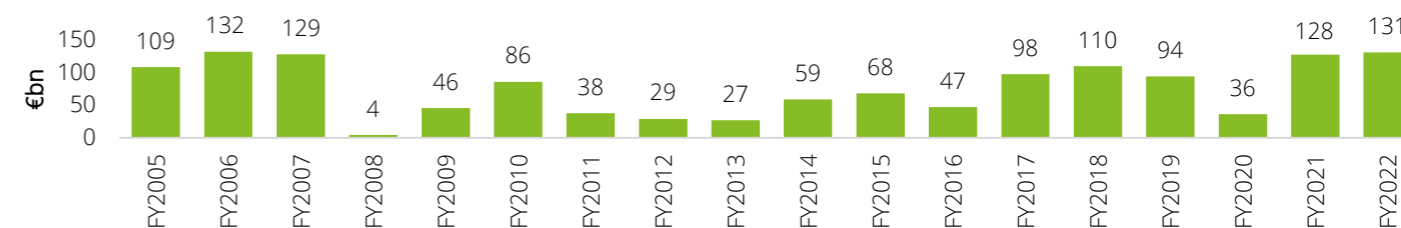
2022 bank performance in context

A year of strong profitability

The European Banking sector performed strongly in 2022. Although only slightly higher in terms of aggregate profitability compared to 2021, the 2022 result was not flattered by writebacks from COVID provisions as was the case in 2021.

For the first time since the GFC and European Sovereign Crisis, net profit after tax for the major listed banks in Europe was over €130bn – the highest level of profit since 2006.

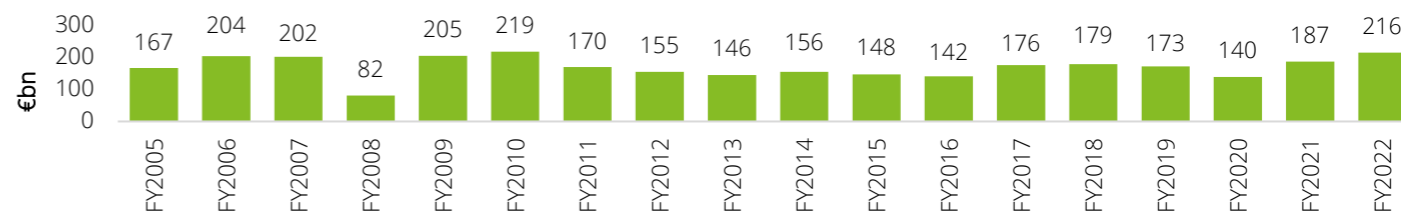
Figure 5: European Banks Net Income after taxes 2005-2022



Source: Refinitiv data, Deloitte analysis. Covers 57 listed banks in Europe at end of 2022 (including the UK)

Excluding the effects of provisioning (which were material in 2020 and 2021), 2022 represented the highest pre-provision profit level since 2010, and higher than the immediate pre-GFC period.

Figure 6: European Banks' pre-provision profit 2005-2022



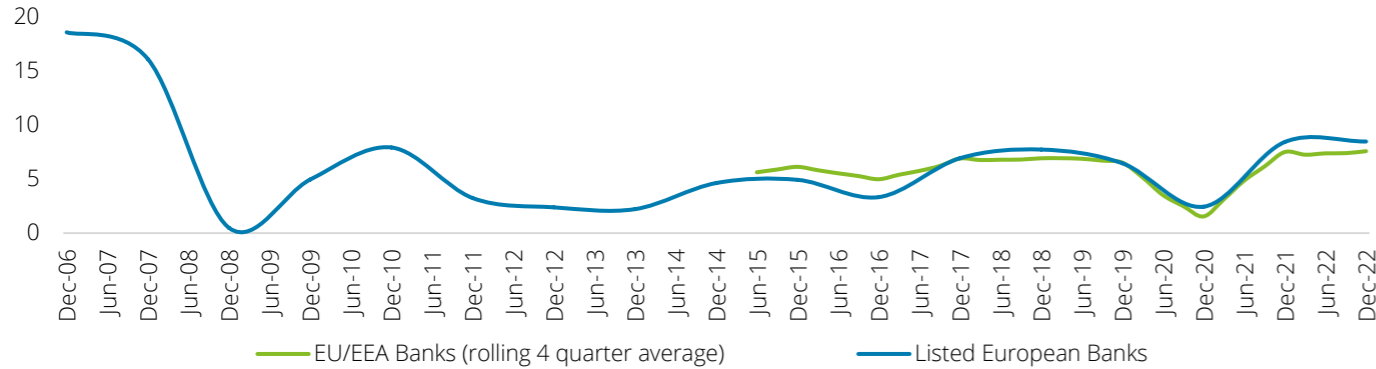
Source: Refinitiv data, Deloitte analysis. Covers 57 listed banks in Europe at the end of 2022 (pre-provision/ pre-tax)(including the UK)

Returns for the sector: ~8% Return on Equity ("RoE") and ~0.5% Return on Assets ("RoA")

RoE (statutory, before adjustments) for the sector was around 8% for 2022 – similar to 2021, 2018 and 2010 – but on a higher equity base.

Though an improvement, this is still below the implied cost of equity for the sector – and well below the pre-crisis period (where leverage was materially higher).

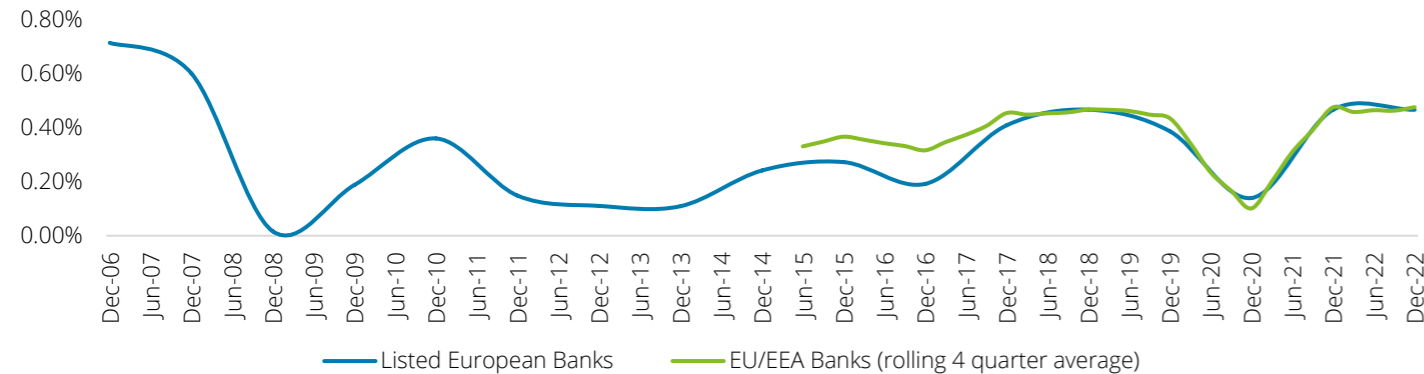
Figure 7: European banks' Return on Equity 2006-2022



Source: EU/EEA Banks is from EBA Risk database (and therefore excludes UK from end of 2020 onwards), Listed European Banks covers 57 banks in Europe at end of 2022 (including the UK)

Removing the effects of leverage, the return on assets for the sector was around 0.5% for 2022 – the highest level since 2007.

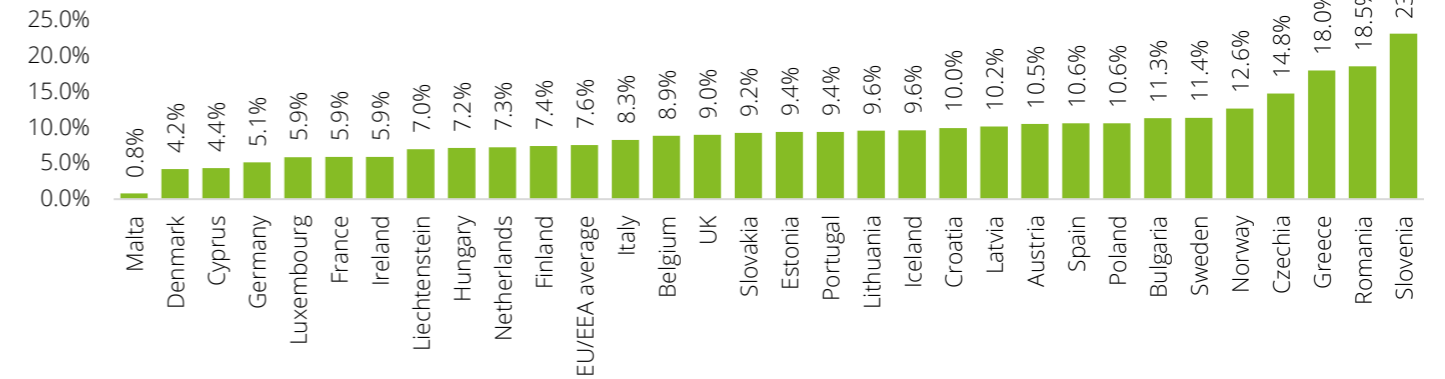
Figure 8: European banks' Return on Assets 2006-2022



Source: EU/EEA Banks is from EBA Risk database (and therefore excludes UK from end of 2020 onwards), Listed European Banks covers 57 banks in Europe at end of 2022 (including the UK)

By country, average RoE performance for 2022 remained broad, with CEE generally well above the overall European average given higher policy rates in non-eurozone countries leading to higher NIM, and 'core' northern European countries such as France, Germany and Netherlands remaining below the EU/EEA average.

Figure 9: European banks' Return on Equity 2022 by Country



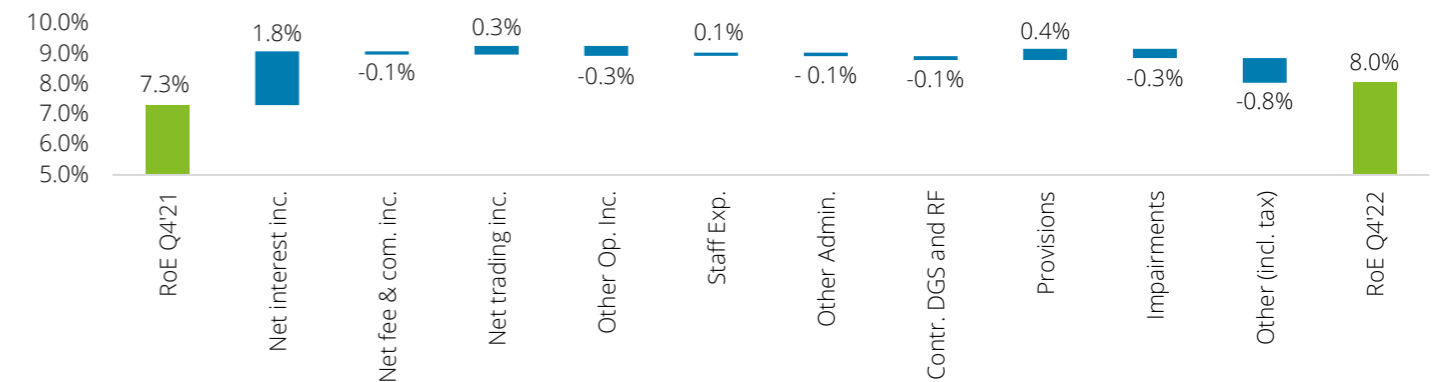
Source: EU/EEA Banks is from EBA Risk database. UK uses simple average from Refinitiv for large and challenger domestics

Profitability driven by an improvement in NIM and NII

This step change in pre-provision performance during 2022 compared with 2021 was driven by a markedly stronger net interest income result (up c.€45bn YoY), aided by the rise in interest rates which drove NIM higher.

The figure below shows a waterfall of ROE from 4Q21 to 4Q22, higher NII contributed ~1.8pp of ROE growth over the last year.

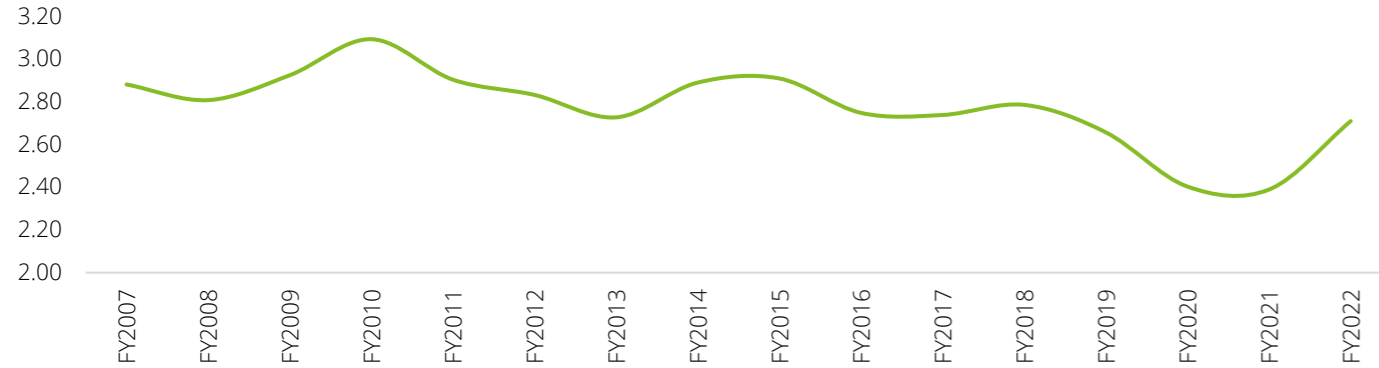
Figure 10: European banks' Return on Equity 2021 -2022 drivers of improvement



Source: EBA Risk Database 4Q22 update (EU/EEA Banks)

This, combined with an increase of non-interest income of ~€27bn more than offset the increase in costs of ~€23bn (with the sector impacted by rising inflation) and more normalised impairment provisions.

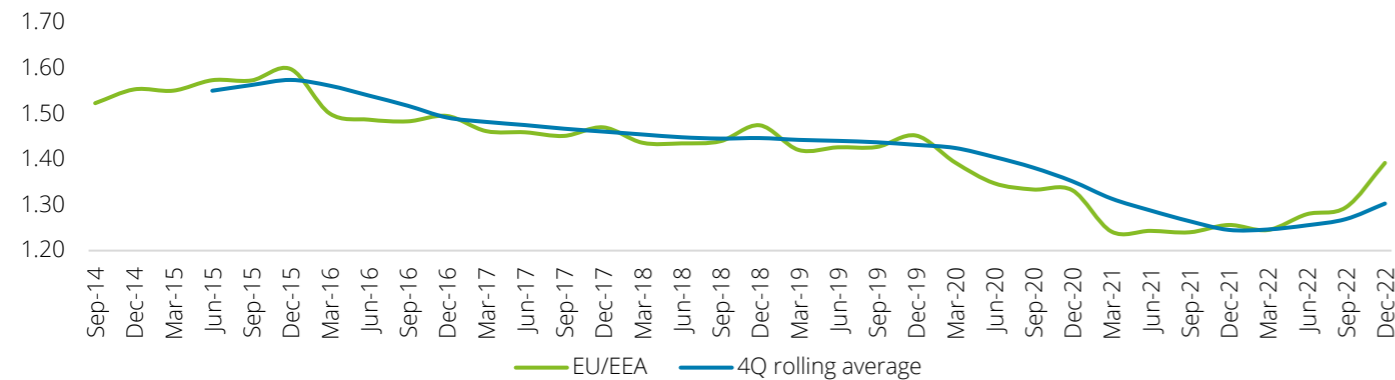
Figure 11: European banks' NIM (%) on customer loans 2007-2022



Source: Refinitiv data, Deloitte analysis. Covers 57 listed banks in Europe as at the end of 2022 (including the UK)

The 4Q22 exit NIM was materially higher than the average for 2022 – indicating that 2023 NIM should continue to improve on 2022.

Figure 12: European banks' NIM (%) on total assets 2014-2022

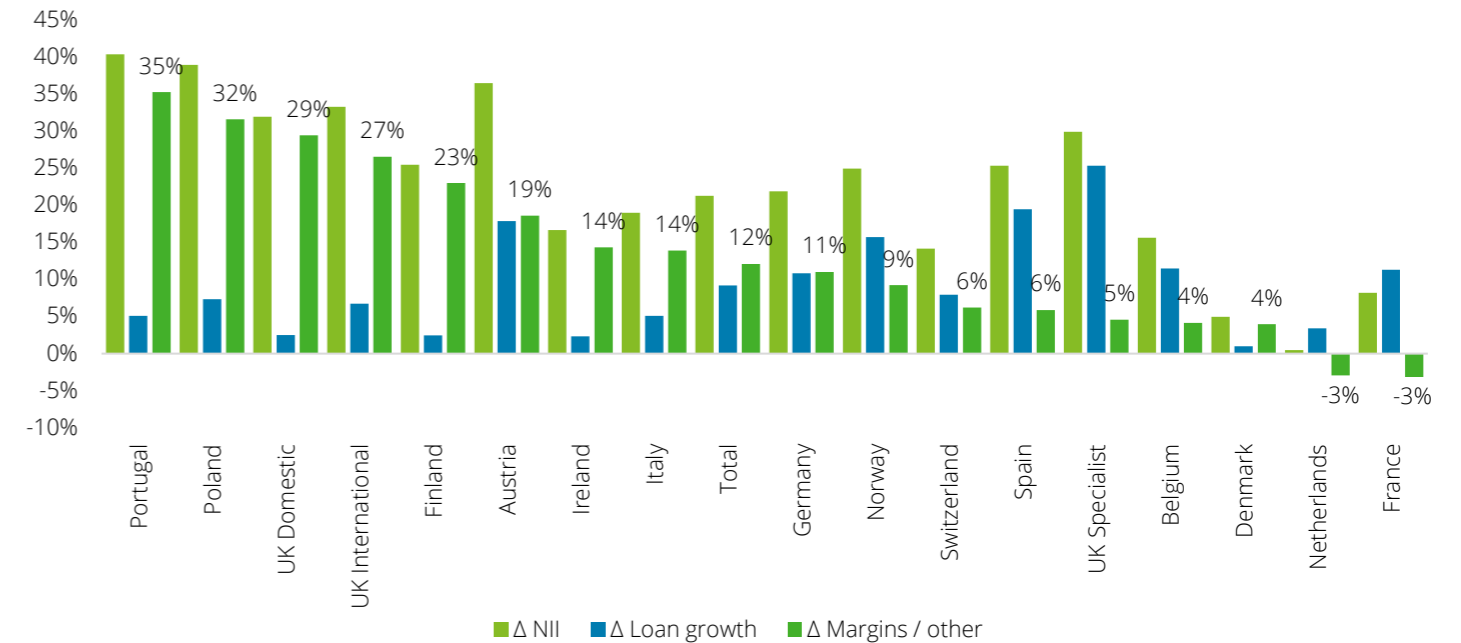


Source: EU/EEA Banks is from EBA Risk database (does not cover UK banks post 2020)

By country across Europe, the impact of interest rates rises has been unequal on banks' results. Markets and sectors where banks are typically more exposed to the shorter end of the yield curve (for example UK large domestics & internationals, Portugal, Ireland, Italy) have seen material benefits from higher rates in 2022 already, notwithstanding monetary policy tightening in a number of other countries (for example Czechia, Poland and Romania) started well ahead of the European Central Bank.

However, banks in countries such as France and Netherlands have seen fewer improvements due to the typically long-dated duration of their assets.

Figure 13: European banking sector changes in NII/ loan growth/ margin by country

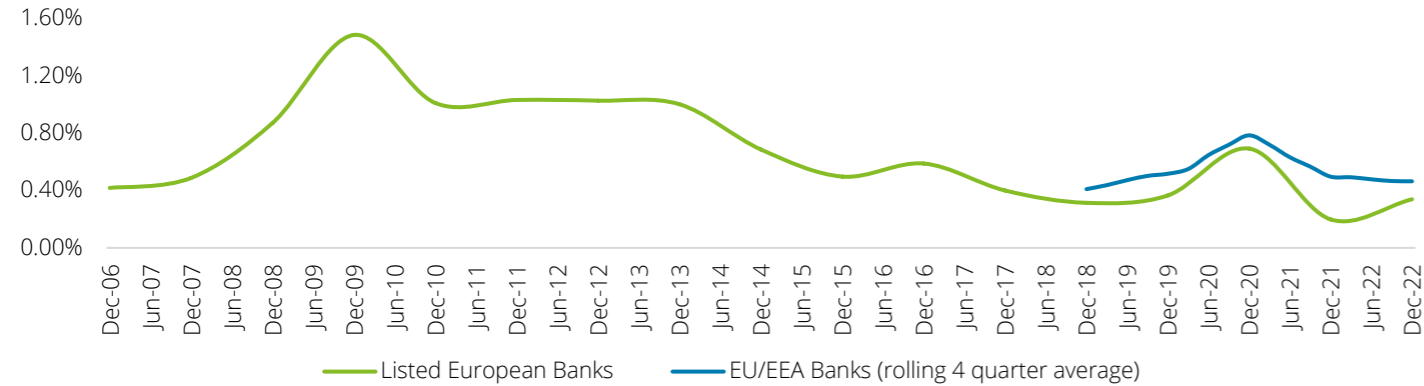


Source: Refinitiv data, Deloitte analysis. Covers 57 listed banks in Europe as at the end of 2022 (including the UK)

Loan losses: uptick, but still low in historical context, with Non-performing exposures (“NPEs”) stable at 4Q22

Though higher than in FY21 (which benefited from partial writebacks of COVID provisions) the cost of risk remains low compared to recent history.

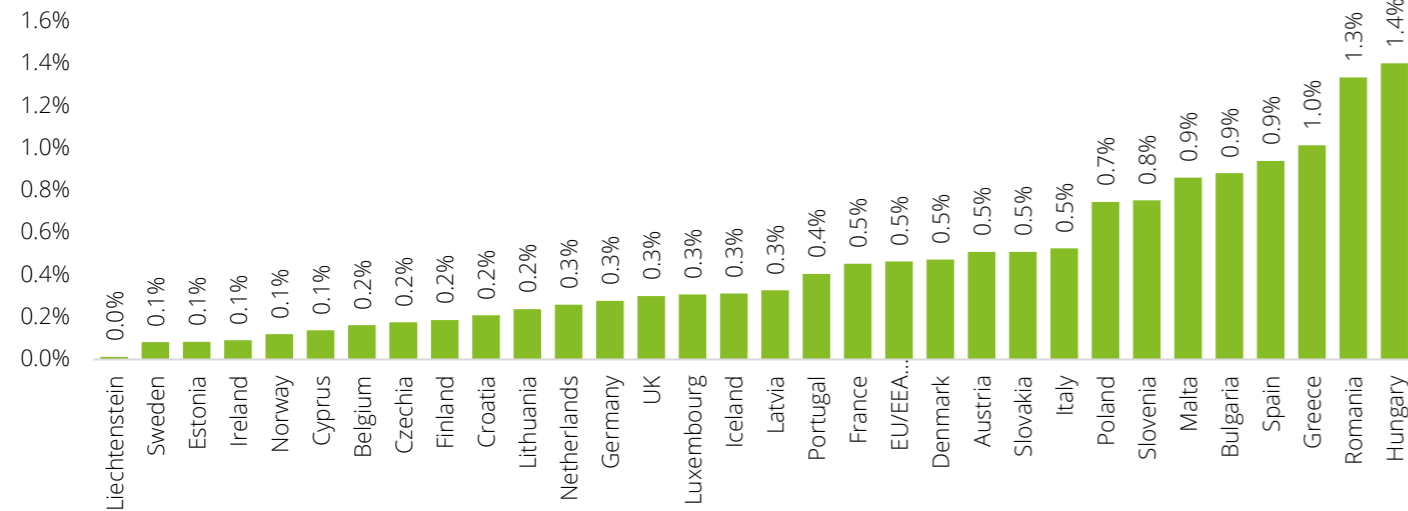
Figure 14: European Bank cost of risk



Source: Refinitiv data, Deloitte analysis. Covers 57 listed banks in Europe as at the end of 2022 (including the UK)

By country, though CEE cost of risk in 2022 remained higher than the rest of Europe (in part a function of the impact of higher energy prices), there were no material outliers.

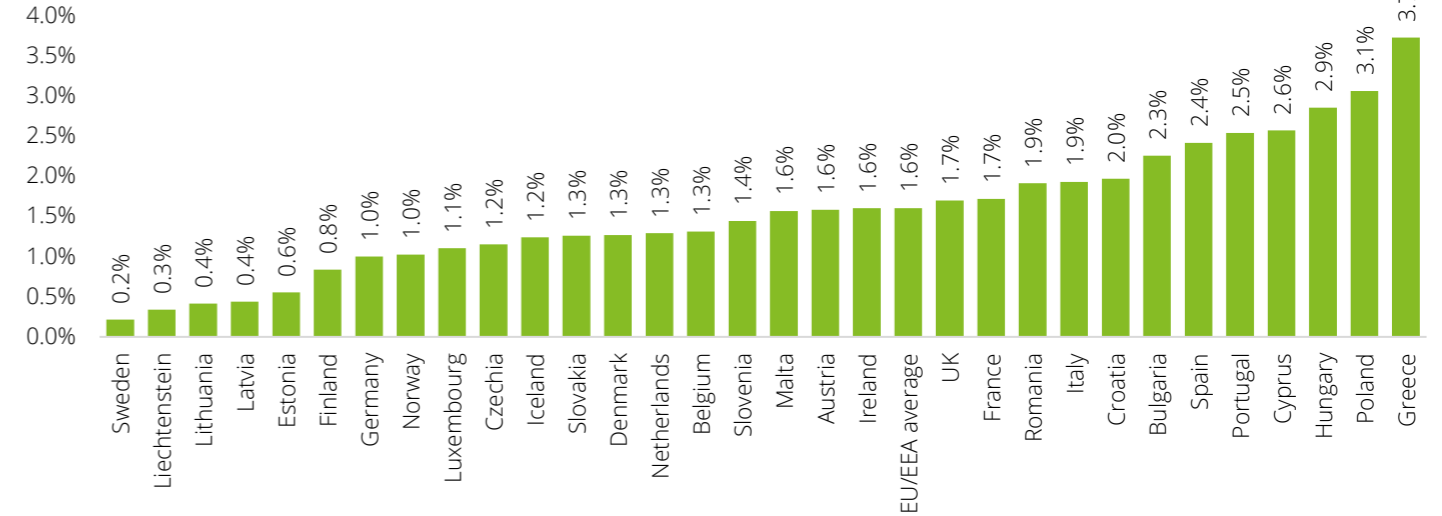
Figure 15: Cost of risk by country



Source: EU/EEA Banks is from EBA Risk database (does not cover UK banks post 2020)

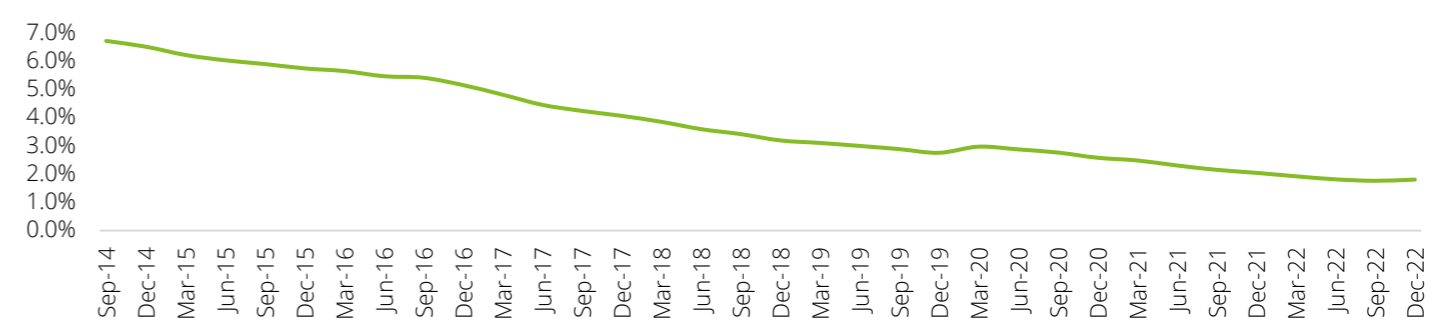
Non-performing Exposures (“NPE”) across Europe stabilised at around 1.6% in 4Q22 but have been falling (almost consistently) since the European Sovereign Crisis. By country Greece still has the highest percentage in Europe (3.7%) but is still down significantly from 5.8% at 4Q21, and 21.4% at 4Q20. At its peak Greece’s NPE ratio reached 42%.

Figure 16: European NPE ratios 4Q22 (by country)



Source: EBA 4Q22 Risk Dashboard. Covers 162 banks in EU, Deloitte analysis. For the UK we used the % of loans classified as Stage 3 considering Barclays, HSBC, Lloyds, NatWest and Santander UK as a proxy for the wider UK banking sector (on a “volume weighted” basis to prevent distortions from balance sheet size)

Figure 17: European NPE ratio evolution 2014-2022

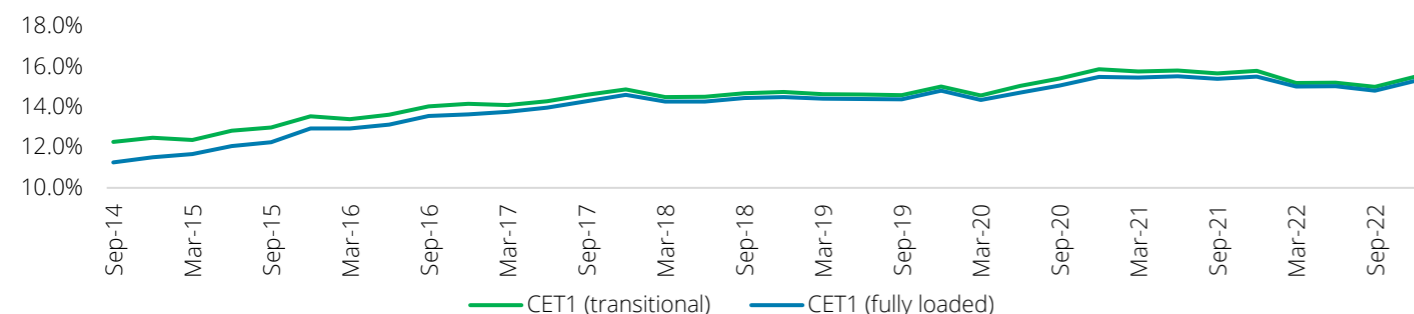


Source: EBA 4Q22 Risk Dashboard. Covers 162 banks in EU (excludes UK from end of 2020).

Capital remains well above regulatory minima

European banks ended 2022 with CET1 ratios well above regulatory minima, and amongst the highest levels in the last decade. The average CET1 for EU banks was 15.5% (15.3% on a fully loaded basis) at the end of 4Q22 – a similar level to the last 3 years, and materially higher than 8 years ago (c.11-12%).

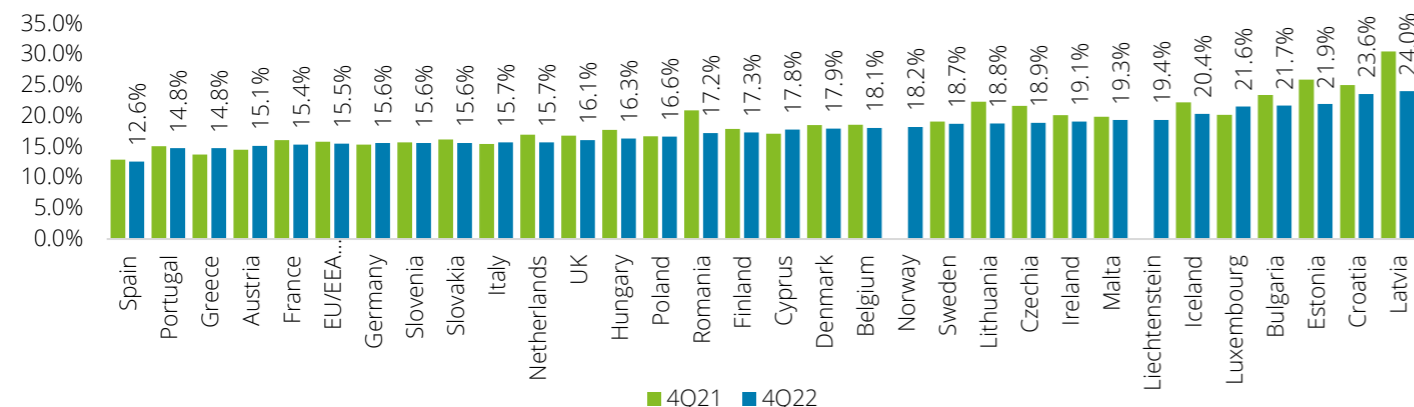
Figure 18: European Banks' Capital position evolution 2014-2022



Source: EBA 4Q22 Risk Dashboard. Covers 162 banks in EU (excludes UK from the end of 2020)

There is a wide range of CET1 ratios across Europe by country, according to where banks are headquartered, but all are above regulatory minimum levels, with Spain showing the lowest levels in Europe.

Figure 19: European Banks' Capital position by country 2021-2022



Source: EBA 4Q22 Risk Dashboard (Covers 162 banks in EU), BoE Banking sector regulatory capital disclosure (total sector)

Capital return (in the form of dividends and buybacks) has been re-initiated at a number of institutions, after suspensions during the COVID period. For the listed major banks in Europe almost all are now paying dividends and around twenty have announced and/or recently completed buybacks. Notably, the buyback plans for BNPP⁸ and Unicredit⁹ were both approved by the ECB after the period of volatility around SVB and CS which suggests that the regulator is comfortable with capital returns despite the volatility (unlike during COVID when buybacks and dividends were halted across the sector).

The sector today trades with a dividend yield (which excludes buybacks) of ~7% for 2023 and 2024.

Liquidity – as at end of 2022 liquidity indicators were robust

Liquidity ratios for the sector overall remain well above the regulatory minimum of 100%. LCR ratios were overall lower in 2022 than in 2020/21 but are still higher than the pre-COVID period, with the significant increase observed from 2020 reflecting growth in customer deposits and targeted longer-term refinancing operations (“TLTRO”) operations.

The EBA expects a downward trend in liquidity and funding ratios due to upcoming repayments of TLTRO¹⁰.

Around 56% of liquid assets were cash and reserves for European Banks in aggregate.

Figure 20: European Banks' liquidity position evolution 2016-2022



Source: EBA 4Q22 Risk Dashboard. Covers 162 banks in EU (excludes UK from end of 2020)

8 <https://www.reuters.com/markets/deals/bnp-paribas-gains-ecb-approval-first-tranche-share-buyback-2023-03-31/>

9 <https://www.unicreditgroup.eu/en/press-media/press-releases-price-sensitive/2023/unicredit-programma-di-riacquisto-azioni-proprie-per-il-2022-da.html>

10 <https://www.eba.europa.eu/robust-eueea-banking-sector-shows-strong-capital-and-liquidity-ratios>

Liquidity ratios vary widely across Europe by country, countries with less mature banking systems generally exhibited higher levels and vice versa.

Figure 21: European Banks' liquidity by country



Source: EBA 4Q22 Risk Dashboard (Covers 162 banks in EU); UK references ratios for major banks as at Feb 2023 (from FPC March 2023 minutes)

...but recent events have highlighted the speed with which liquidity positions can change

However, recent events have re-focused attention on bank liquidity positions, in particular the perceived 'stickiness' of deposits (or not as the case may be), the exposure of certain business models to wholesale markets, and unrealised losses in treasury books. For SVB and Credit Suisse (and most recently First Republic), the level of deposit withdrawals, were far in excess of the outflows expected under the Liquidity Coverage Ratio definition forcing regulators to reconsider other measures to protect the system.

While we think that these events reflected idiosyncratic issues rather than a structural problem with the sector more broadly, we expect bank management teams, regulators and investors to reflect carefully on recent events.

The regulatory implications of these recent events are discussed in more detail in a later section.



Valuation, outlook and key themes for the sector

Despite stronger 2022 profitability & outlook, bank valuations remain low

Valuations for the European banking sector – even before the volatility during March – were subdued, despite the improved returns that the sector produced in 2022 and which are forecast to grow further in 2023/24.

Price / Book ratios for the sector are around 0.66x in aggregate – higher than the lows of the GFC, European Sovereign Crisis, Brexit aftermath and COVID – but still well below pre-GFC levels, and lower than the levels seen during the 2013-2015 period.

Figure 22: European Banks' price/ book ratio (as at 31 May 2023)

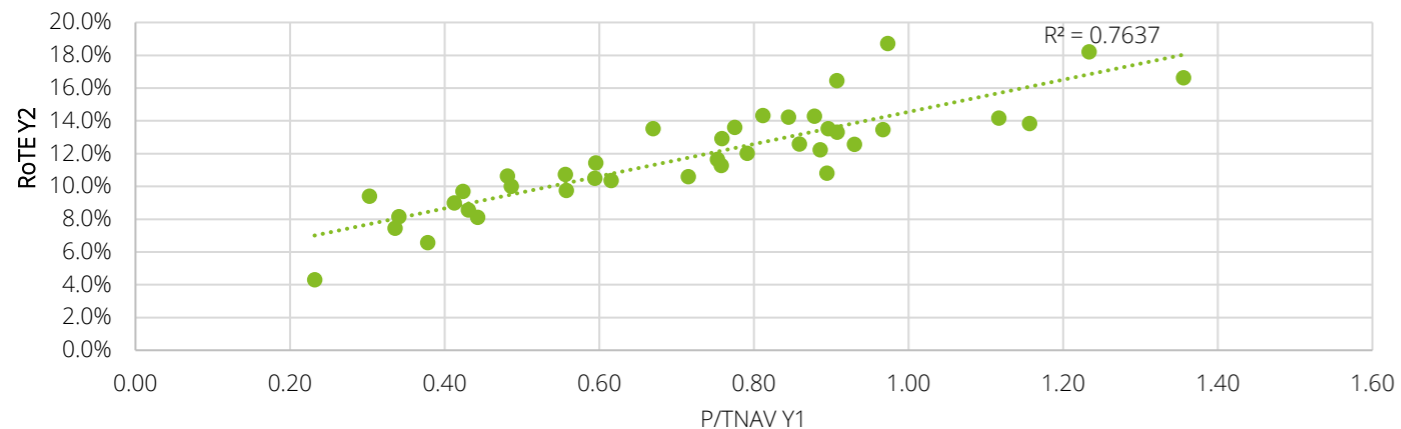


Source: Refinitiv (SX7P)

The regression of forecasted 2024 RoTE (“Statutory Return on Tangible Equity”) for the major listed European Banks against respective 2023 Price / Tangible Book Value (“P/TNAV”) continues to suggest a high correlation between earnings outlook and valuation (c.80% R-squared). On this basis, a forecasted 2024 RoTE of 10% aligns to a valuation of just 0.6x TNAV.



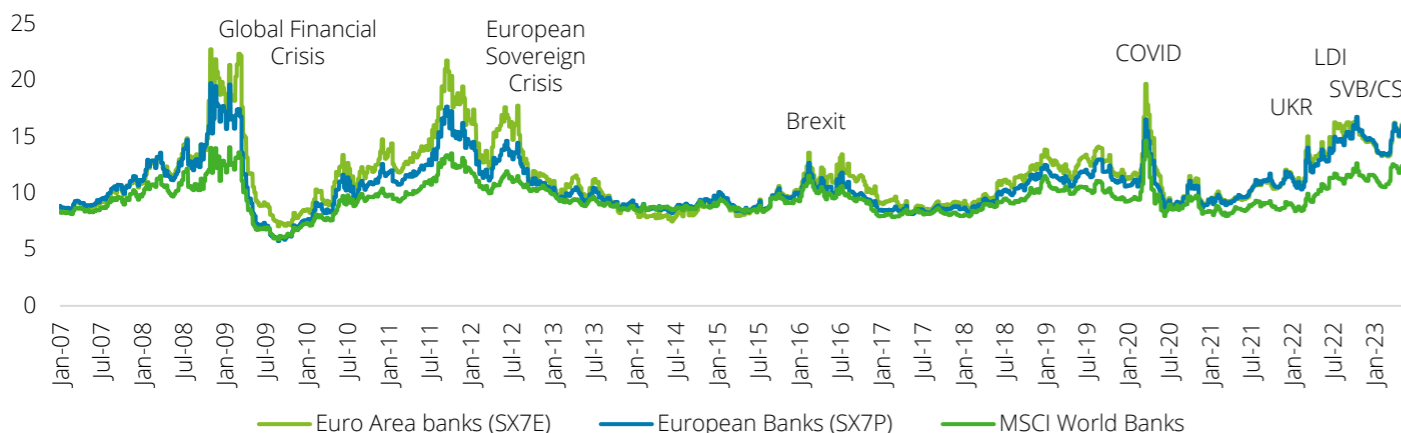
Figure 23: European Banks' Valuation Regression (as at 31 May 2023)



Source: Refinitiv data, Deloitte analysis

This indicates a high implied cost of equity for the banking sector – over 14% at time of writing. Compared with the last 15 years this is high, COE has only been higher during the GFC, European Sovereign Crisis, initial COVID period and during mid-2022 following the invasion of Ukraine and around the LDI challenges.

Figure 24: European Banks' Implied Cost of Equity (CoE)



Source: Refinitiv data, Deloitte analysis. COE derived as inverse of 1 year forward P/E

The long-run average over the last 23 years has been ~10% COE for European Banks, however pre-GFC it was ~8% and over the last decade has been ~10.5%, with a clear CoE 'premium' for European Banks compared to Global Banks in the last 5 years. There is not one specific factor as to why the cost of equity is as high as it is - nor is it clear whether the cost of equity will ever revert to the pre-GFC trend in time.

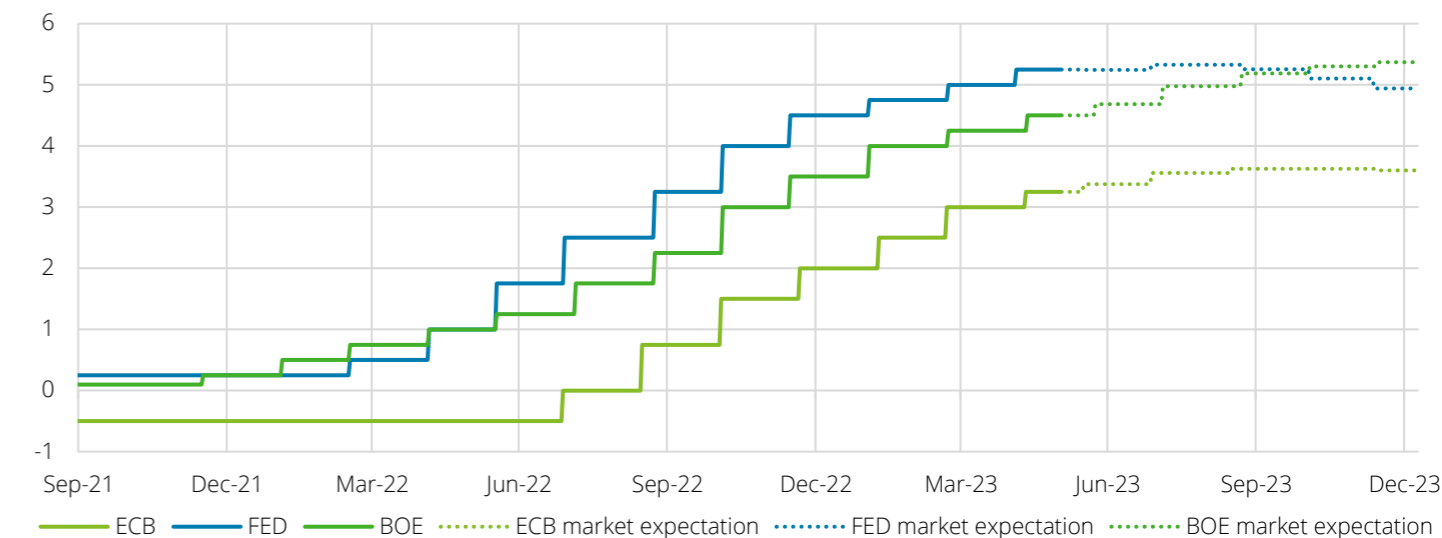
Most likely the high COE reflects market uncertainty on both the level, the sustainability and quality of the earnings' base – as well as pricing in 'unforeseen' risks and costs which were either not assessed or deemed to be small in the pre-crisis era. Recent interventions by the regulator have served as reminders that market confidence in bank performance, liquidity and solvency can rapidly change.

Key themes and outlook for 2023/24

1. Interest rate expectations – moderating, but base effect will benefit 2023 performance

The outlook for interest rates has changed markedly since the beginning of the year in the face of high inflation across the globe, with central banks in many leading economies increasing rates on successive occasions. In recent weeks and months market expectations for future interest rate changes have remained volatile – while rates in the US may be close to their peak, in the EU and UK the market is pricing in further increases to help tame inflation.

Figure 25: Interest rate decision history – and market expectations until end of 2023 for ECB, FED and BOE (as at 31 May 2023)



Source: Refinitiv Datastream, Deloitte analysis

- The **Bank of England (BOE) base rate** increased 25bps to 4.50% on 11 May 2023, with markets currently pricing a ~97% probability (at the time of writing) of a further 25bps hike in June with further likely increases in the Summer/ Autumn potentially reaching over 5.25% by December.
- The **US Federal Reserve** increased the Fed Funds target rate by 25bps to 5-5.25% in May, and at time of writing the market is pricing that this most likely stays constant until November, when probabilities of a reduction increase.
- The **ECB deposit facility rate** increased its benchmark deposit rate by 25bps to 3.25% on 4 May 2023, the seventh consecutive rise since mid-2022, with markets currently pricing further increases later in 2023 (with c.50% probability of rates reaching 3.75%).

Considering rates were at 0.25%, or lower, across all three economies at the beginning of 2022, and had been low (or negative) for a number of years before that, this higher rate environment has had, and continues to have a material impact on the performance and outlook for the banking sector. We consider there are perhaps four key implications for 2023 and beyond:

- **First**, higher interest rates have driven better margins and NII in 2022. Given interest rates were higher in 4Q22 than at the beginning of the year, and have since risen further, this should provide a **strong base effect for further improvement in 2023**.
- **Second**, though starting from a higher base, **margin and NII momentum is likely to slow over the course of 2023** given we are closer to peak rates, deposit betas (the proportion of interest rate rises passed through to depositors) have started to rise, and COVID-era central bank facilities (e.g., Term Funding Scheme for Small Medium Enterprises (“TFSME”), TRLTO) costs and repayments are increasing. This will differ depending on country-specific interest rate structures (those more exposed to the shorter-end of the curve are likely to see momentum slow fastest) and by institution (depending on the mix, quality and growth in funding required).
- **Third**, credit standards tightened in the second half of 2022 and loan demand was more subdued in 2022 in the face of rising interest rates, lower consumer confidence for households and lower demand for fixed investments at companies. The most recent ECB Bank Lending Survey¹¹ reported that net demand for loans had decreased in 1Q23 across households, large corporates and SMEs. For enterprises this was the largest net decline since 4Q08 and was particularly acute for long-term loans. In 2Q23 banks expect a further, albeit smaller, net decline in demand for loans across enterprises and households. **Lending for 2023 could therefore be somewhat subdued, and in certain areas this lower loan demand could, in our view, drive further competitive pressures on margins.**
- **Fourth**, after a decade of low interest rates and low cost of funding across both the banking and non-banking sectors, funding cost disparity has returned and will remain a key factor driving both strategic and M&A decisions in our view. The new environment may change lending product economics and strategic focus for particular lenders. This should mean a **greater focus on relative balance sheet strength and potential financing structures in an M&A context**, which may change the buyer universe and appetite for a particular asset.

2. Capital & Liquidity – funding costs likely to rise

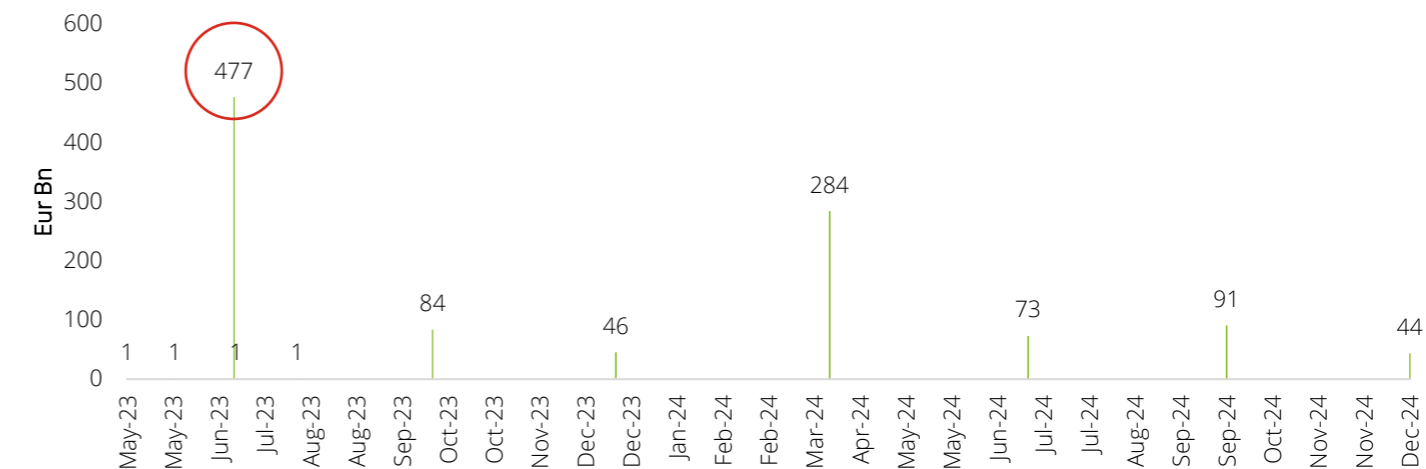
As noted earlier, banks across Europe ended 2022 with strong capital and liquidity positions. However, while the stresses experienced at SVB, for example, may have been idiosyncratic, for other European banks and non-banks the impact from recent events is likely to be felt

¹¹ https://www.ecb.europa.eu/stats/ecb_surveys/bank_lending_survey/html/ecb.blssurvey2022q4~e27b836c04.en.html#toc5

most acutely in the near-term through higher funding costs. (Regulatory implications of the recent stresses in banking markets are covered in more detail in the next section.)

- **AT1, senior preferred, senior bail-in and tier 2 spreads** all rose sharply during mid-March, and though these have recovered somewhat, AT1 spreads in particular remain elevated following the full write-down of CS instruments – that this happened ahead of equity was unexpected and caused both resolution authorities in the UK and Europe to issue their own clarification statements. In the near term, this has increased the potential new issue risk premia for banks when accessing the primary debt markets given ongoing investor caution resulting from recent market volatility.
- **Repayment of COVID-era central bank facilities** are also upcoming, with ~€477bn of outstanding TLTRO3 funding due to mature at the end of 2Q23. A further €284bn is due in March 2024. In the UK, the durations are longer: the TFSME drawdown window ran from April 2020 to October 2021 with a duration of 4 years (extendable to 10 years for Bounce Back Loans (“BBLs”) loan balances). This means maturities should begin in April 2024 but with most maturities due from October 2025 (or later if an extension was applied).

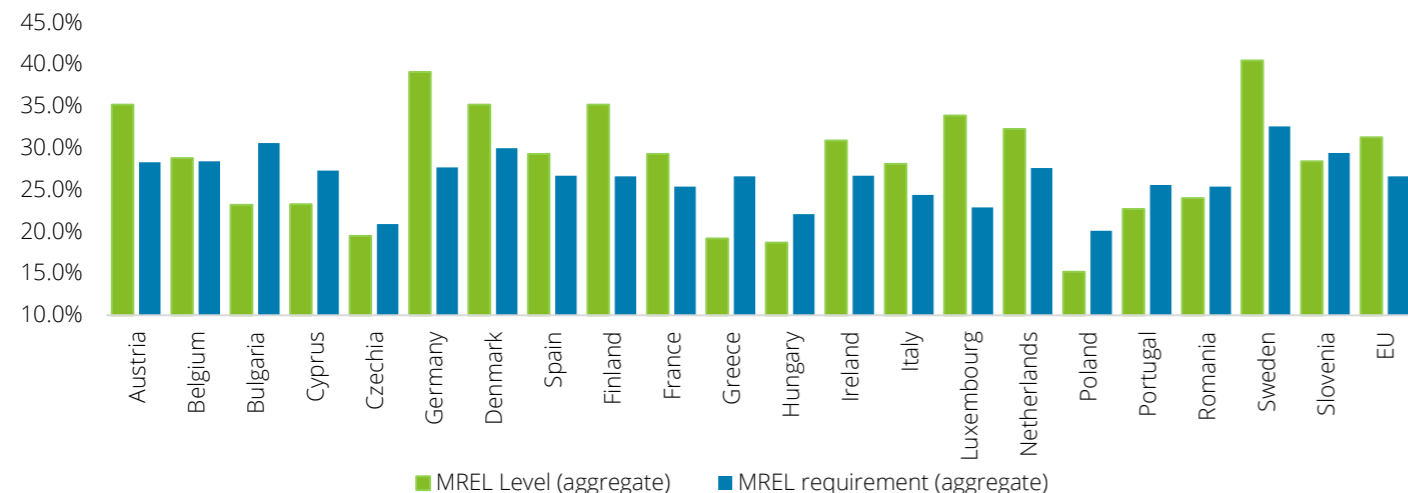
Figure 26: TLTRO Repayment schedule and volumes



Source: ECB Open Market Operations (as at 14/4/23) <https://www.ecb.europa.eu/mopo/implementation/omo/html/index.en.html>

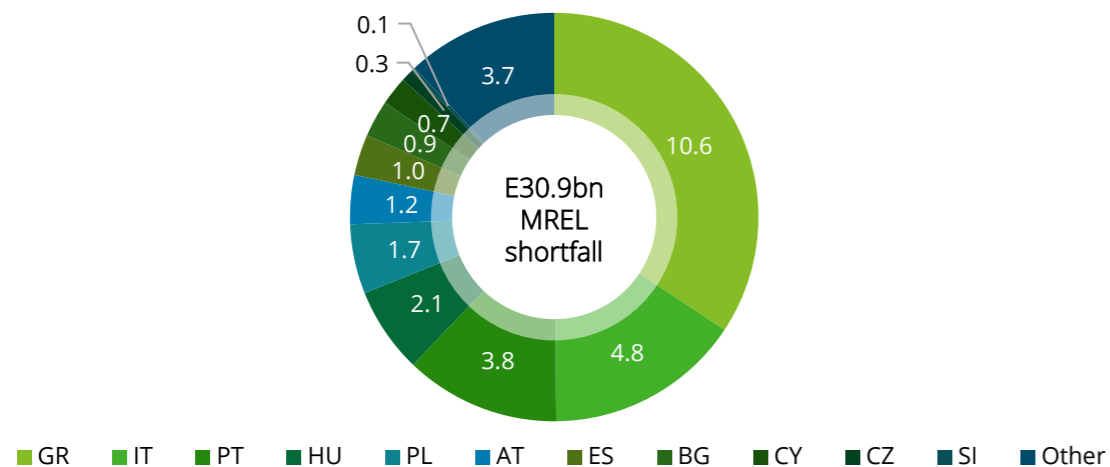
- **MREL issuance:** there has been significant progress in MREL issuance across Europe - and at an aggregate sector level, the level of MREL across the EU at 3Q22 was 31.1% - above the requirement of 26.6%. However, some countries and banks are still operating below the required levels. The EBA estimated an overall MREL shortfall of €30.9bn as at 3Q22, with Greece contributing a large proportion of the total (€10.6bn). MREL issuance costs have likely risen in the aftermath of the volatility during March, and MREL is an important consideration for banks looking to grow organically or inorganically, especially as accessing the debt capital markets can be a challenge for small and medium sized banks even in strong market conditions.

Figure 27: MREL issuance vs requirements by EU country



Source: EBA MREL Dashboard 3Q22

Figure 28: MREL shortfall by EU country



Source: EBA MREL Dashboard 3Q22

- Though banks are holding significant cash balances, at an overall sector level there is the possibility that these funding market dynamics may drive further increases in deposit costs (with potentially greater implications for smaller deposit-funded banks than larger franchises), and thus enhanced appetite for consolidation amongst smaller institutions.

3. Asset impairments are still low, but management teams need to be vigilant

In general, and notwithstanding COVID and more recent events, NPL volumes have been falling not rising in recent years as an aftermath of the European Sovereign Crisis and aggregate sector level loan growth has not felt excessive. But, as always, we expect there will be specific sectors and banks and non-banks which are more exposed – so there is a need for management teams to be vigilant to any credit deterioration.

Impairments for European Banks have so far remained low with losses (as % of loans) at around 35bps during FY22 for the sector overall, and the recent issues at SVB and CS being unrelated to concerns around credit quality.

Despite cost-of-living challenges, household credit quality indicators have so-far remained stable, and guidance from bank management teams has generally been benign. We note that in the BoE’s 1Q23 Credit Conditions Survey, lenders reported that default rates and LGD on secured loans to households increased in 1Q23 and are expected to increase further in 2Q23 – but we should caveat that this would be off a very low base of arrears. Elsewhere default rates increased for SMEs in Q1 and were expected to increase again in 2Q23.

Current consensus expectations are for cost of risk to increase to c.50bps for the sector in 2023-25 – higher than in FY22 but not materially so, nor above the through-the-cycle average.

However, where investors do appear increasingly focused is on the potential risks of a credit crunch for US Commercial Real Estate (“CRE”) in particular as a large proportion of CRE¹² loans are financed by small and medium banks in the US, which may now be more cautious in maintaining liquidity in the aftermath of events at SVB. Recent commentary has suggested some US banks are actively considering selling US commercial real estate and property loans at a loss¹³.

The Implications for this, for US CRE-exposed banks, and knock-on implications for any overspill into European markets remains to be seen and is likely to be a key area of focus for 2H23.

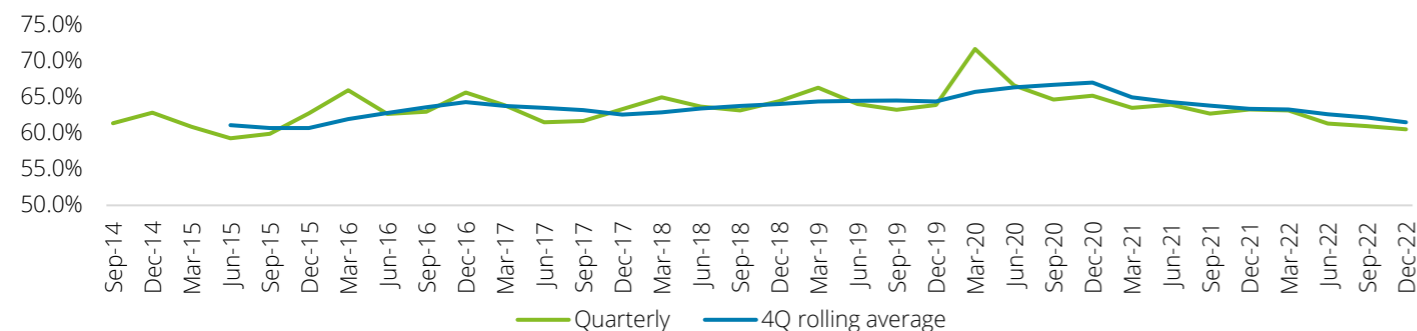
12 Financial Times - <https://www.ft.com/content/c172f9f4-0175-40ea-bcb5-01026ddd8ee>

13 Financial Times - <https://www.ft.com/content/3e905e3c-697c-4109-bd9a-605e75a0cfa4>

4. Cost inflation

European banks' cost/income ratios improved during 2022 – primarily due to improved income performance.

Figure 29: European banks' cost income ratio



Source: EBA 4Q22 Risk Dashboard. Covers 162 banks in EU (excludes UK from the end of 2020)

However, banks are not immune to cost increases given many technology costs will be linked to inflation and staff costs have been increasing also. As such, we expect a greater focus on cost control efforts across the sector, in particular a review of business lines and processes that have been particularly impacted.

As discussed below, M&A activity (either through divestment or acquisition) or strategic partnerships may serve as an opportunity to improve cost/income ratios and improve business unit economics.

5. Bank M&A activity is likely to continue

Interest rates may be higher, but long-term value creation will require further growth in bottom line earnings. We expect many lenders will be re-reviewing their strategies and areas of focus considering the change in interest rate and economic environment, and specifically how to drive further earnings momentum after interest rates peak. Here we expect M&A activity will continue to play a role, particularly given fewer organic growth opportunities. Though there remains a gap between seller and buyer expectations, we expect this to close over time or to be bridged by an unforeseen market event resulting in accelerated M&A. For smaller participants, a near term challenge for any acquisition which involves higher levels of RWAs is the resulting cost of additional MREL funding, which could affect transaction pricing or feasibility given the impact higher funding costs could have on transaction economics.

In general, we see these in five areas to consider:

A. Business combinations: consolidation within the European banking sector (from small privately owned assets to large publicly

listed banks) has been a long-discussed theme, but one which, during the period of low interest rates, often lacked a catalyst. The transformation in interest rate environment, with implications for business models as well as capital and funding sources for smaller institutions, could change this. **Consolidation may provide an opportunity to grow bottom line profitability through synergies in the context of lower growth and pressure on profitability.** Consolidation drivers are clearest for in-market M&A, driven by synergies and product diversification opportunities – but also for geographic simplification, Fintech, and payment-related capabilities.

Figure 30: M&A business combination drivers

	In market M&A driven by synergies and product diversification	Geographical simplification	Fintech-related	Payments-related
Main Drivers	Competitive pressure	Competitive pressure	Competitive pressure	Competitive pressure
	Regulatory support	Regulatory support	Regulatory support	Regulatory support
	Cost efficiency	Cost efficiency	Cost efficiency	Cost efficiency
	Returns potential	Returns potential	Returns potential	Returns potential
	Valuation	Valuation	Valuation	Valuation
	Capital efficiency	Capital efficiency	Capital efficiency	Capital efficiency

Source: Deloitte

- B. Performing loan portfolios:** in particular, acquisitions which can improve scale in existing products and take advantage of wider funding cost differences today than in recent years. For some banks and non-banks we expect divestments of assets, which are either now non-core, or where they are non-competitive, to release capital and liquidity.
- C. Non-performing loan portfolios:** we would expect European banks to proactively look to manage non-performing exposures lower, potentially via loan sales, in the event that the current ongoing challenging economic situation leads to higher loan defaults.
- D. Platforms in market adjacencies:** exploring adjacent sectors or markets outside their traditional product bases to drive greater growth. For example, platforms which could offer wealth products to existing clients, or lending platforms which offer adjacent products.
- E. Partnerships:** We expect continued appetite to create new partnerships and alliances which could drive access to new customers and potential new sources of revenue (for example between banks and financial institutions such as non-bank lenders, payments businesses, insurers, wealth and asset managers as well as BigTech) as well as further demand for forward flow agreements which allow businesses to originate product for institutions with excess liquidity – particularly relevant given the recent funding market dislocation.

Implications of recent market stresses for regulation

This section is an updated version of an article originally published by the EMEA Regulatory Strategy Team (David Strachan and Scott Martin) on 30 March 2023 <https://emearegulatorystrategy.deloitte.com/post/102ibru/the-impact-of-current-stresses-in-global-banking-markets-on-the-future-regulatory>.

The significance of the events of the last weeks

In the last few months, global banking markets have been extremely turbulent, driven principally by events in the US and Europe. These events are being analysed extensively and our understanding of their root causes will undoubtedly improve as new information emerges.

However, banking supervisors are already taking rapid action to ensure that the failings that drove several regional banks in the US and one Global-Systemically Important Bank (G-SIB) in Europe to the point of failure are not repeated. They will expect banks' Boards and senior management teams to be doing the same. Any lessons learned will undoubtedly feed into the medium- and longer-term regulatory policy agenda. The Basel Committee on Banking Supervision (BCBS) has already "agreed to take stock of the regulatory and supervisory implications stemming from recent events, with a view to learn lessons"¹⁴. That said, we do not expect the BCBS to rush to make changes to its capital framework, given that the existing Basel 3.1 package has yet to be implemented fully.

This note sets out our views on European regulators and supervisors' near-term priorities and, beyond that, the questions we expect them to be asking themselves about the impact of recent events on their current and future policy agenda.

¹⁴ Pablo Hernández de Cos's speech on the future of the macroprudential framework tools. <https://www.bis.org/speeches/sp230324.pdf>

Immediate supervisory priorities

In the immediate term the questions for supervisors will include: how well banks are set up to identify and react to liquidity vulnerabilities; are banks doing enough to manage interest rate risk in the banking book; are supervisors and banks comfortable with the treatment of assets held at amortised cost; and what are the implications of recent events for the AT1 market.

- **Liquidity vulnerabilities:** we have now had our first real experience of a bank run in an era of widespread online banking, instant or near instant payments and rapid transmission of information and speculation on social media. Recent events show liquidity ratios and holdings of High-Quality Liquid Assets (HQLA) are not calibrated for a deposit run of the magnitude or speed experienced by some of the banks which failed. Moreover, fire sales - even of HQLA - can impose losses on a bank and rapidly erode previously strong levels of capitalisation. We expect supervisors to:
 - identify banks with vulnerable liquidity profiles such as concentrations of balances above deposit insurance thresholds;
 - challenge banks on how well they can manage intraday liquidity;
 - require banks to develop better early warning indicators to spot emerging runs;
 - ask potentially vulnerable banks to increase the stock of HQLA;
 - ask banks with access to central bank lending facilities to preposition collateral to enable rapid drawdown of liquidity if needed;
 - require banks to toughen their stress tests and revisit recovery plans, including liquidity funding plans; and

- make more use of Pillar 2 liquidity approaches.

This will be coupled with ongoing supervisory scrutiny in the EU of diversification of banks' funding sources, with supervisors already expecting banks to need to increase reliance on market-based funding as TLTRO III winds down.

- **Interest rate risk in the banking book (IRRBB):** EU and UK supervisors already examine banks' IRRBB through the Pillar 2 framework. The ECB has noted that "substantial supervisory work" has been undertaken to tackle banks' vulnerabilities to interest rate risk. The PRA has also taken a robust approach to IRRBB, including using Pillar 2A add-ons to reflect deficiencies it has found in individual banks' approaches.
 - Supervisors will expect Boards and Board Risk Committees to be asking searching questions about interest rate exposures, challenging the executive on how well these risks are really understood and managed and whether the assumptions underpinning their own scenarios and stress tests are sufficiently severe. In addition, banks of all sizes should be ready for ad hoc requests for information on their IRRBB positions.
- **Scrutiny of assets held at amortised cost:** we expect supervisors to examine the extent to which EU and UK banks hold securities on an amortised cost basis, and the extent to which doing so may be concealing unrealised mark-to-market losses.

- This may be less of an issue among EU and UK banks¹⁵. Under the asset classifications available under IFRS 9, there is a category of assets that are held at amortised cost, but this is not as widely used by UK/EU banks as the "hold-to-maturity" (HTM) category is by banks under US GAAP. Nevertheless,

¹⁵ Bank of England Governor Andrew Bailey's response letter to the Chair of the Treasury Committee Harriett Baldwin MP sets out that "On average major UK banks' and building societies' bond portfolios held at amortised cost make up around 3% of their total assets", which is considerably lower than for some US regional banks. <https://committees.parliament.uk/publications/34533/documents/190168/default/>

supervisors will be looking for outlier banks which have significant amortised cost portfolios and subjecting them to additional scrutiny/stress testing. Under IFRS 9, transfers of securities from amortised cost to fair value or vice versa are very uncommon, as they are only permitted when a change in the bank's business model happens. We would therefore anticipate significant regulatory challenge of any proposed transfers of securities between available for sale and amortised cost portfolios.

- **Implications for the AT1 market:** supervisors will be keeping a very close eye on conditions in the AT1 market and assessing the implications of a shift in investor appetite for AT1 instruments for banks' ability to reduce existing MREL shortfalls. The EBA's December 2022 Risk Assessment Report highlighted that, even before the recent market turmoil, both pricing (i.e. the spread between MREL-eligible and non-eligible instruments) and investor demand were constraining MREL issuance by EU banks.

Medium-term implications (next 12 months)

In the medium term, supervisors will redouble their efforts in relation to recovery plans, particularly for banks with structural vulnerabilities in their business models; and they may face calls to push for stronger regulatory standards, particularly for liquidity. In the UK, we could see the PRA revisit aspects of its proposed Simpler Regime for smaller banks and, in the EU, a tougher stance on third-country branches (TCBs).

- **Recovery plans:** we expect supervisors and banks to revisit the triggers for activating recovery plans, with a particular focus on whether they enable banks to activate their plans early enough, especially in a "fast burn" crisis. This will include looking at early warning indicators such as CDS spreads, share price movements, shifts in price to book value, social media sentiment and other early signs of distress. Supervisors may expect banks to stand ready to activate recovery plans at times of significant events,

such as raising capital in the market.

- **Business model sustainability¹⁶:** recent events have demonstrated that even banks with healthy levels of regulatory capital and liquidity can be taken to the Point of Non-Viability (PONV) very quickly when creditors and investors lose confidence in the viability of a bank's business model. They also show how business model doubts can be exacerbated by seemingly unrelated events in banking markets that make participants more risk averse. While better recovery plans may be a stop-gap solution, addressing the underlying causes of the business model vulnerabilities is the more effective remedy.
 - Supervisors are likely to place an even greater emphasis on analysing structural vulnerabilities in bank business models and take earlier and more intrusive action when they identify deficiencies. Tougher reverse stress testing may be used to help identify underlying weaknesses in a bank's business model. Supervisors will expect Boards and senior management teams to be able to demonstrate that they have a viable and sustainable business model and are taking timely and effective action to remedy any vulnerabilities. Supervisors could press for granular actions tied to specific dates and outcomes and linked to senior management responsibilities (not only in countries with individual accountability regimes).
- **Banks' use of capital buffers:** it is not yet clear whether recent events will lead banks to reduce their supply of loans to the economy and to a general tightening of credit conditions, and/or an increase the provision of credit by non-bank financial institutions. There are concerns that this may happen, but no strong evidence of it yet. However, if this is the outcome, we would expect the debate about the usability of banks' capital buffers to resurface, given supervisors' clear view that buffers are there to

¹⁶ This Financial Stability Institute Insights Paper summarises the supervisory approach to assessing the sustainability of banks' business models. <https://www.bis.org/fsi/publ/insights40.pdf>

be used in stressed conditions to enable the flow of lending to support economic activity to continue.

- **Stronger regulatory standards:** recent experience will strengthen UK and EU regulators' arguments that long-term financial sector competitiveness is best served by maintaining high regulatory standards that are consistent with international agreements. This may slow or halt what has been growing political and industry pressure to find ways to reduce the burden of the regulatory regime to support international competitiveness. The implementation of Basel 3.1, which is currently in consultation in the UK and in final stage negotiations in the EU, will be crucial in this.
 - The PRA is currently consulting on a **Simpler Regime for smaller banks in the UK** (as set out in CP5/22 and CP4/23). The PRA has proposed a £20bn asset ceiling for being considered a "simpler" bank, along with restrictions on trading activity, a prohibition on provision of settlement or clearing services, and stringent limits on the proportion of non-UK activities¹⁷. The extent to which the PRA will progress with these proposals as currently set out remains to be seen. They could potentially be vulnerable to shifts in political discourse around bank risk, regulation, and the UK competitiveness agenda (see above).
 - The speed with which **deposit runs** played out during recent events was unprecedented. This in turn raises questions about the calibration of the current liquidity frameworks (LCR and

¹⁷ Current Simpler Regime proposals include:

- Disapplying NSFR and associated reporting and disclosures if a bank can demonstrate it meets a new "retail deposit ratio", which measures use of relatively more stable retail funding.
- Not applying Pillar 2 liquidity guidance to Simpler-regime banks, except where idiosyncratic risks are identified.
- A new enhanced internal liquidity adequacy assessment process template.
- Removing the requirement for Simpler-regime banks to report four out of the five regulatory liquidity returns.
- Reducing (for listed Simpler-regime banks) or eliminating (for non-listed ones) capital and liquidity disclosures.

NSFR). This may form part of the “lessons learned” exercise which the BCBS is conducting. One key question will be what level of stress these ratios should be designed to withstand. Some may characterize the speed of runs we have seen as “extreme”. Others will argue that the fact that they have happened mean that they are “severe but plausible” and that banks therefore need to be ready to withstand them.

- The **appropriate supervisory treatment of TCBS** is currently being debated as part of the EU’s CRD6/CRR3 Banking Package proposal. Given the EU principle of applying all regulatory requirements to banks of all sizes, some EU policymakers could argue that the EU should impose even more restrictive conditions on allowing TCBS to access EU markets, especially if their home supervisor does not apply Basel 3.1 across-the-board. This may reignite the debate in the EU about the forced subsidiarisation of at least some TCBS. We do not expect the PRA’s long-standing approach to the treatment of TCBS to change.

Longer-term implications (12 months and beyond)

Longer-term, questions for global, UK and EU regulators will revolve around the effectiveness of the resolution regime, especially as it applies to G-SIBs and D-SIBs, the balance between going and gone concern capital and liquidity, the G-SIB and D-SIB frameworks and the role of deposit insurance. In the UK, HMT will think carefully about its position on ring-fencing.

- **The future of bank resolution and deposit insurance regimes:** supervisors, resolution authorities, deposit guarantee schemes and the banks themselves have spent the last ten years trying to make sure that no bank is “too big to fail” such that, even if a large bank runs into difficulties, it can be resolved in an orderly fashion without recourse to public funds. There is no doubt that significant progress has been made. However, the bank resolution regime was not applied consistently in recent events

and the Swiss Finance Minister has concluded that a G-SIB cannot be wound up in line with its resolution plan. Other authorities will take a different and more positive view of the feasibility of resolution for G-SIBs, given the published results of resolvability assessments in the US and the UK and their authorities’ experience of using resolution tools. Nevertheless, the Financial Stability Board has indicated that its members will assess what, if any, lessons should be learned from recent events. We also expect some regulators to consider what changes can be made to deposit guarantee schemes in order to support financial stability outcomes better or to facilitate the use of resolution tools such as the EU’s recent Crisis Management and Deposit Insurance proposal has sought to do.

- **Going and gone concern capital:** in light of the above, there may be questions about whether regulators should insist that the largest banks hold even higher levels of going concern capital and liquidity, to reduce the likelihood that they reach the PONV. This does, however, sit awkwardly with the evidence from recent events that high levels of regulatory capital and liquidity do not always prevent banks from being brought to the PONV in a period of market stress.
- **UK ring-fencing regime:** HMT recently published a call for evidence in relation to the ring-fencing regime. As part of this, HMT asked whether the UK authorities should be able to remove banking groups from being subject to ring-fencing if they were judged to be resolvable. Recent developments could influence the extent to which the Government and the UK authorities are prepared to rely fully on the resolution regime as an alternative to ring-fencing.
- **G-SIB and D-SIB frameworks:** the BCBS may choose to look again at the metrics governing G-SIBs and D-SIBs and consider how they could evolve to capture banks that are too small to be designated as individually systemic, but which could collectively be seen as “systemic as a herd”, or banks that have a dominant

position providing lending or other financial products to a significant sector/industry.

- **Competition in the banking system:** in response to widespread concerns about regional banks in the US, many depositors have moved their deposits to the strongest banks and money market funds¹⁸. This, particularly if it is replicated in other countries, together with recent questions about the feasibility of applying resolution tools to G-SIBs, will inevitably increase concerns about the largest banks becoming even larger. However, what the solution to this is, in particular whether there is political appetite to constrain the size of banks, remains unclear.

¹⁸ <https://www.ft.com/content/032523bc-3b92-4b94-b6b8-ebbe1d606b2c>



Basel 3.1 & Climate risk implementation update

Regulatory change and supervisory activity in 2023 will carry implications for the amount of capital that banks must hold against certain assets. This could come at a time when banks are facing pressure from deteriorating credit quality and increased supervisory scrutiny around their management of risks.

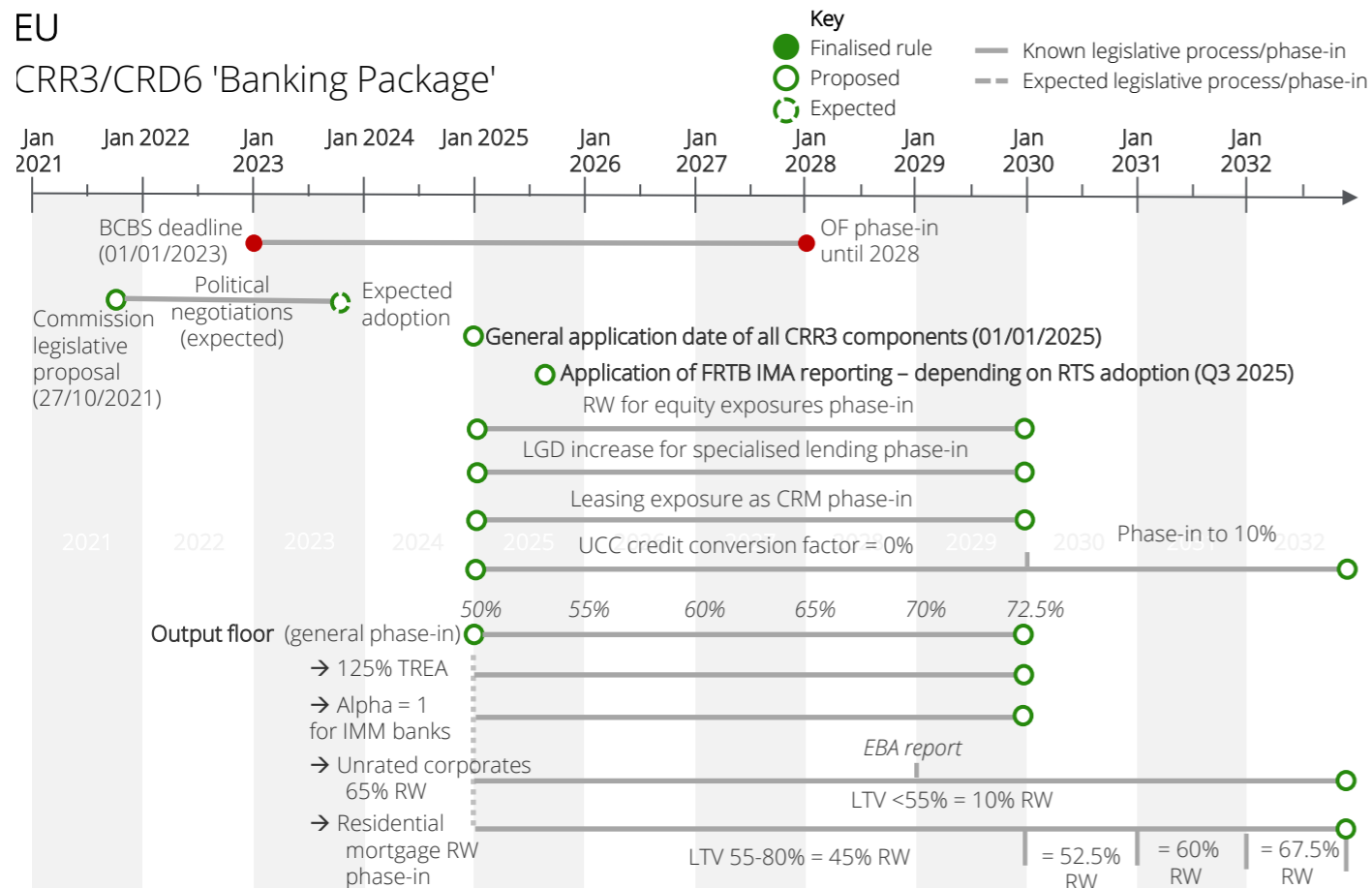
Basel 3.1 implementation

The biggest single regulatory initiative in the bank capital space today is the worldwide implementation of the final Basel 3 revised standards for bank capital requirements (known as Basel 3.1 in the UK). Policymakers in both the UK and the EU are aiming to implement these rules by 1 January 2025 (with phase-in periods running until 2030 (UK) and 2033 (EU)). In order to achieve the initial target, both jurisdictions are likely to have their final standards in place by the end of the year.

European banks are widely expected to be disproportionately impacted by Basel 3.1 implementation versus their peers in other regions; this is primarily due to the difference in reliance on internal models in the EU versus in the US/Asia Pacific region ("APAC"), and subsequent higher impact of the output floor. The European Banking Authority ("EBA") estimates that a full implementation of the framework would lead to an increase in Tier 1 Minimum Required Capital ("MRC") for banks of 15%. Even considering the EU-specific adjustments that have been included in the EU's Banking Package legislation, which implements Basel 3.1, the EBA still expects Tier 1 MRC inflation of 10.7% by the end of the transition period.



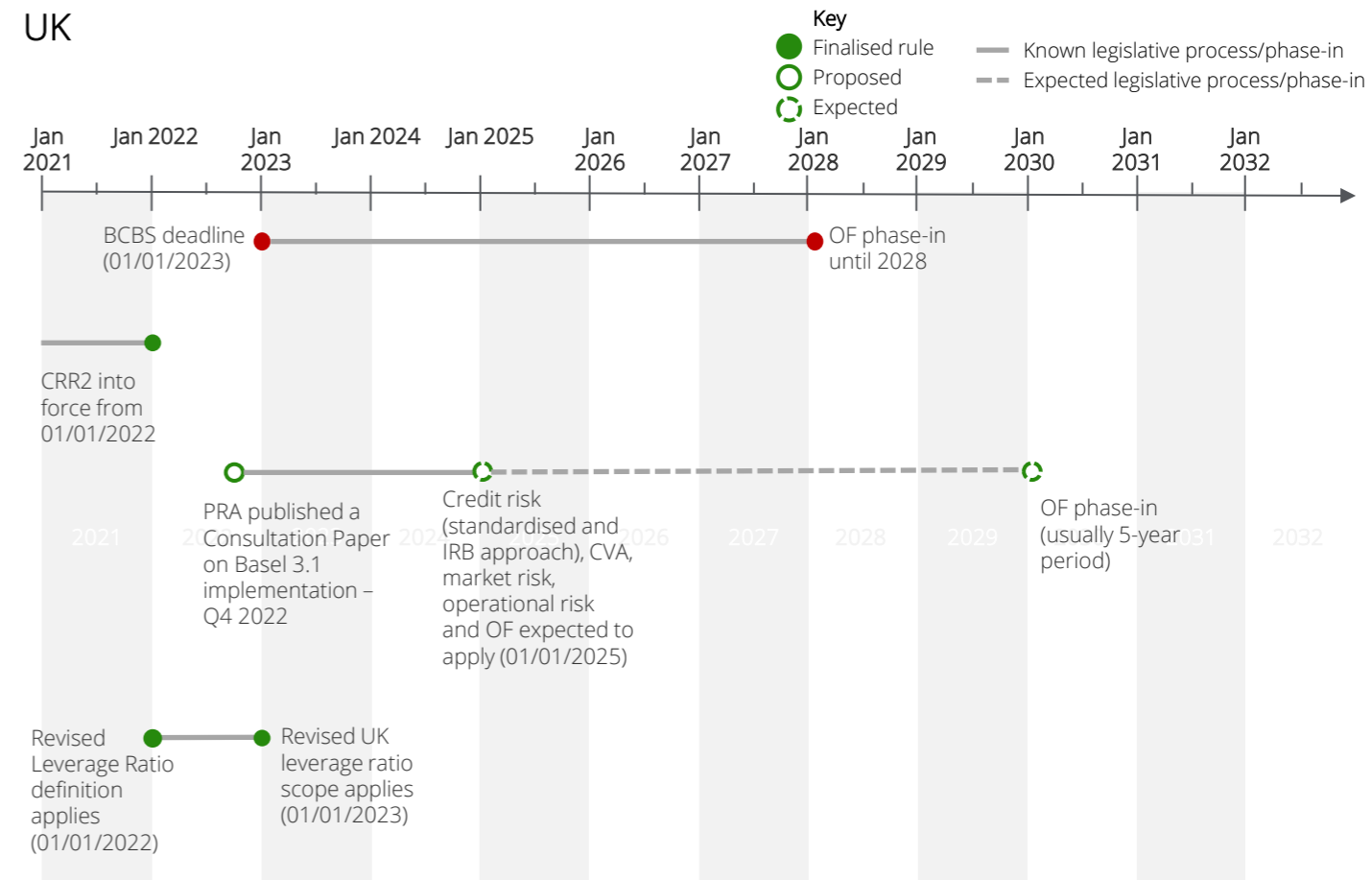
Figure 31: Basel 3 implementation timeline (EU)



Source: Deloitte based on public information

In the UK, the Prudential Regulation Authority (“PRA”), which proposed its approach to Basel 3.1 implementation in November 2022, forecast a smaller increase of 3.1% CET1 for UK banks following full implementation. Unlike the EBA analysis, however, it reached this figure through a number of assumed offsets, such as lower Pillar 2 capital charges.

Figure 32: Basel 3 timeline (UK)



Source: Deloitte based on public information

Interestingly, one of the offsetting assumptions it made was that the implementation of the Basel 3.1 framework would lead to management decisions by banks to alter their exposures to Risk Weighted Assets (“RWAs”) most affected by the revisions. In doing this, the PRA forecast that UK banks would reduce their overall RWAs by 1% in response to Basel 3.1 implementation, and that PRA-designated investment firms would reduce their RWAs by 1.8%.

Climate risk and capital

An ongoing policy priority for regulators and supervisors in the EU, UK and beyond is banks' management of climate-related financial risks.

Although policy discussion has now largely moved away from the potential imposition of measures that would have a direct impact on bank RWAs and capital (such as green supporting/brown penalising factors in the prudential framework), both the European Central Bank ("ECB") and PRA expect banks to holistically integrate climate risks (and, increasingly, broader environmental and sustainability risks) into their business strategy, governance and risk management. Supervisors are scrutinising increasingly closely whether the processes and strategies that firms have put in place are having an impact on how they steer their business.

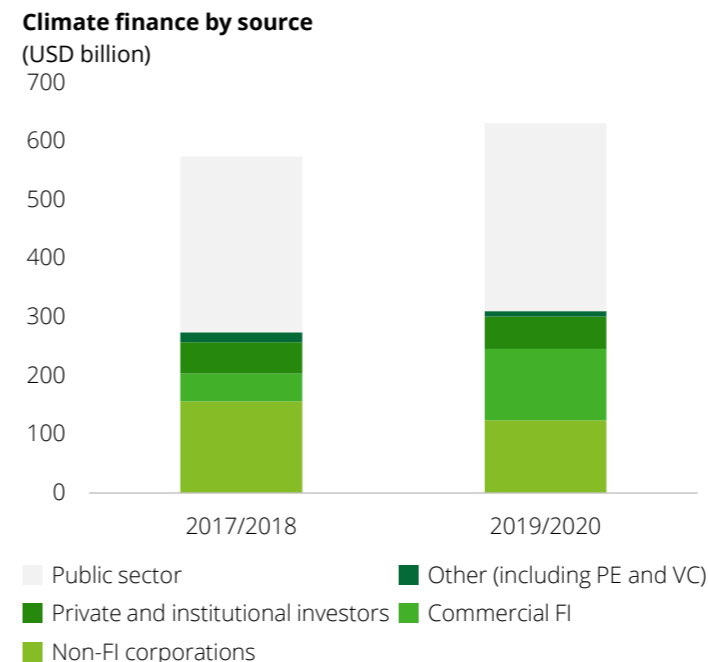
Consequently, banks will be expected to take an increasingly active approach to managing their climate risk exposure – both through "top down" strategy setting and risk appetite processes, and "bottom up" processes that advance their climate strategy and adhere to their climate risk appetite (such as changes to lending policies, counterparty engagement and exits from sectors or client relationships where necessary).

Notwithstanding growing public and private sector understanding of the importance of "transition finance", in the short, medium and long-term banks are likely to reduce their exposure to certain counterparties, sectors or geographies in order to reduce their own exposure to climate-related risks (both physical and transitional). Similarly, as supervisory scrutiny of banks' management of broader environmental, social and governance ("ESG") risks intensifies, some may choose to exit from (or at least reduce their exposure to) portfolios that have a negative impact on other sustainability objectives, such as nature preservation or human rights. High polluting entities, particularly those slow to make the transition to lower emissions, are at risk of becoming "stranded assets", precipitated by changes in government policy, taxation, regulation, the development of lower emission alternatives or general changes in consumer preferences.

ESG Integration

Given increasing regulatory pressures and scrutiny, climate risk and ESG considerations are also being progressively integrated into the management of the balance sheet, factored into lending considerations, and used as a key performance indicator for investment decisions, as part of the development of the ESG Target Operating Model ("TOM")

Figure 33: Climate finance issuance



Sources: Climate Policy Initiative (December 2021)

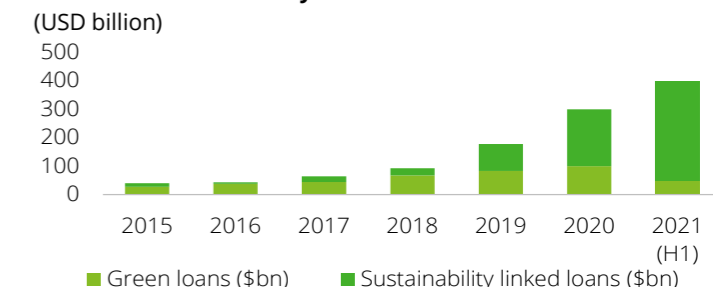
As set out above, climate finance is growing in importance and an increasing focus on ESG is required to achieve net-zero.

The increase in ESG relevance has also attracted the attention of rating agencies who have historically built ESG-related scores into their bank rating opinions. However, there is now a more distinct focus on certain aspects of ESG driven by industry consensus and regulatory demand.

For example, in December 2022, S&P acquired the Shades of Green business from CICERO (Center for International Climate Research), Norway's foremost institute for interdisciplinary climate research, and has begun to focus on integrating Shades of Green into its framework, including climate and transition risks / frameworks, and in-depth strategies to meet net-zero targets, rather than broader ESG or sustainability topics.

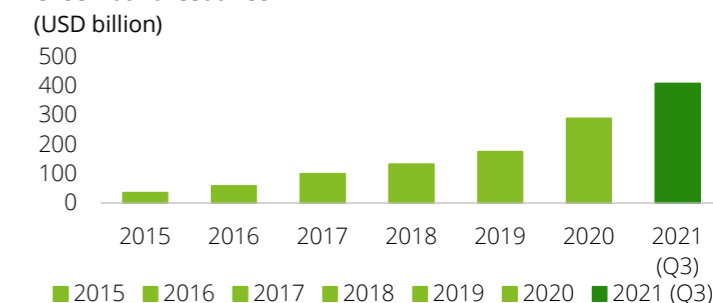
This will closely align S&P's assessment criteria with regulations such as Task Force on Climate-related Financial Disclosures ("TCFD") that heavily focus on these particular areas, expand the breadth and depth of their offerings for banks, and ensure ratings are reflective and relevant through regulatory reforms.

Green and sustainability-linked loan issuance



Sources: Climate Bonds Initiative, Nordea, S&P, Refinitiv and Deloitte analysis

Green bond issuance



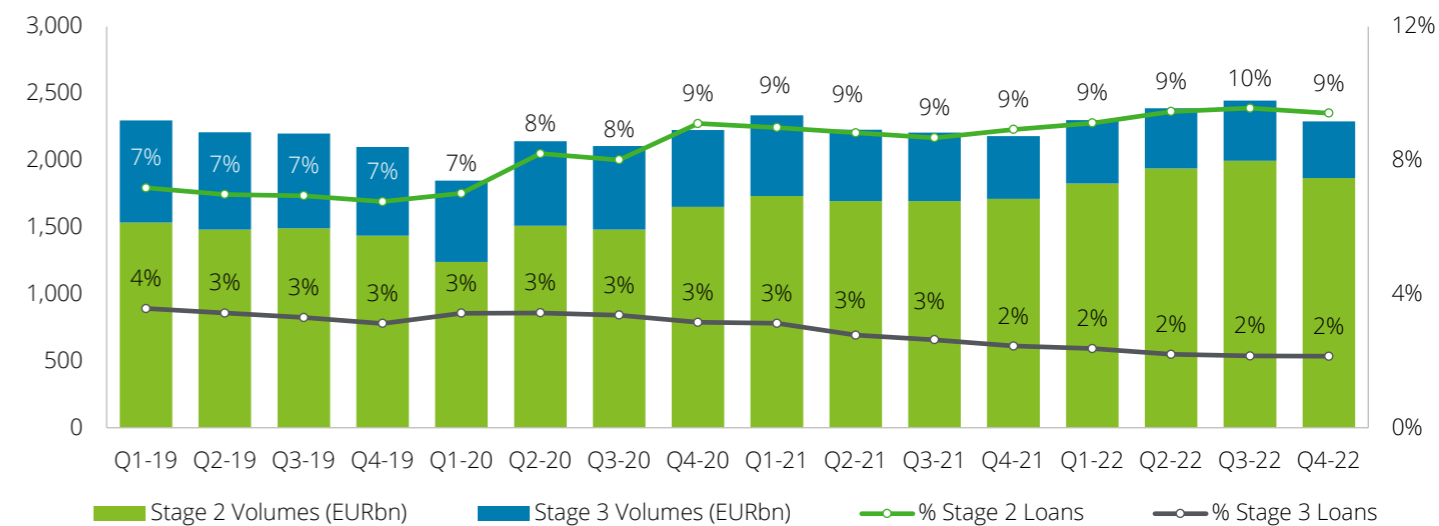
Sources: Climate Bonds Initiative, Nordea, S&P, Refinitiv and Deloitte analysis

Loan portfolio transaction activity and outlook

In Europe, the GFC resulted in a profound impact on bank asset quality with, at its peak, European banks holding in excess of €2 trillion¹⁹ of non-performing and non-core loan assets on their balance sheets. Today, the volume of NPLs has reduced significantly and as at 4Q22 stood at less than €500 billion (considering NPLs only), with institutional investors acting as a key beneficiary of wholesale loan portfolio divestment strategies employed by lenders and state-owned institutions across the continent. In certain European markets, such as Italy and Greece, banks (in particular) continue to divest such assets through portfolio activity – albeit at significantly reduced levels of volume – on the primary debt sales market whilst across Europe we have increasingly seen investors themselves now divesting of previously acquired portfolios (typically via off-market arrangements and secondary debt sales) as they approach the end of fund/investment lifecycles.

From an asset quality perspective, the percentage of loans classified as Stage 3 continued its overall downward trend from 3.6% in 1Q19 to 2.1% in 4Q22. While the share of Stage 2 loans decreased slightly to 9.4% in 4Q22 from 9.6% in 3Q22, levels remain elevated compared to 2019 (7.2% as at 1Q19), hinting at ongoing vulnerabilities which could translate into higher NPLs in the future, if ongoing challenging macroeconomic conditions persist for any lengthy period of time.

Figure 34: Asset Quality (EU banks)



Source: EBA Q4 2022 Risk dashboard (excludes UK from end 2020). Although excluded from the EBA analysis after 4Q20, for UK banks we estimate ~1.7% Stage 3 and ~12% Stage 2 as at 4Q22 (UK levels based on a weighted average of the top 5 banks).

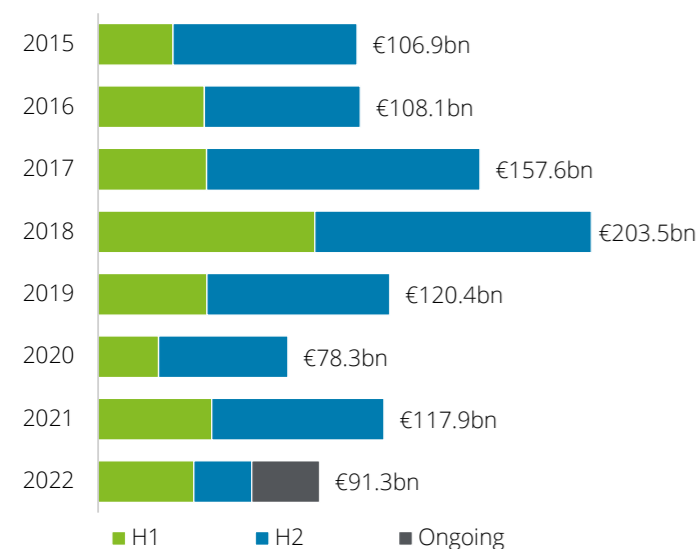
¹⁹ Breugel

Loan portfolio market

Loan portfolio transaction activity

Deal flow, which had recovered in 2021 as markets reopened as COVID lockdowns were eased, fell back again in 2022, with €63.4bn traded in the year (and €27.9bn ongoing as at 4Q22), through a combination of resilient asset quality and as higher interest rates and macroeconomic uncertainty dampened investor appetite.

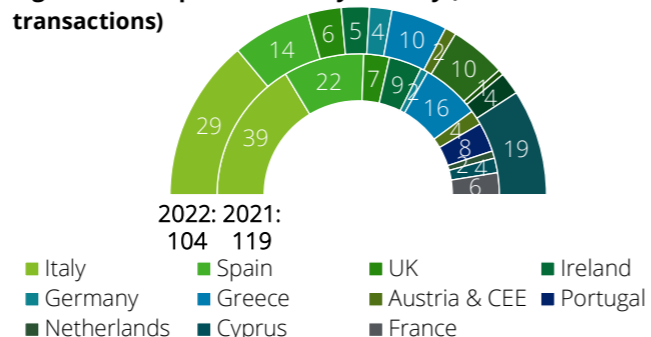
Figure 35: European Activity by year (€bn)



Source: Deloitte analysis based on publicly available information - as at 4Q22

Italy regained its spot as the most active market, both in terms of volumes (~€30bn traded) and number of deals (29 transactions (39 in 2021)) and is anticipated to remain relatively busy notwithstanding legacy stocks of NPLs have been substantially worked through.

Figure 36: Completed deals by country (number of transactions)



Source: Deloitte analysis based on publicly available information

While Italian banks have dominated the portfolio sales market over the past few years (over €355bn traded or ongoing as at 4Q22 since 2015), France has, since 4Q19, overtaken Italy in having the highest volume of NPLs in Europe. As of 4Q22, the total volume of NPLs held by French banks amounted to ~€111bn, broadly unchanged since 4Q21. Italian stocks of NPLs have, contrastingly, continued to fall from ~€116bn as at 4Q19 to €46bn as at 4Q22.



Table 1: Volume of European NPL stocks by Country (€bn)

Country	4Q19	4Q20	4Q21	4Q22	GFC max	Ranking 4Q22/(4Q19)
France	120.16	119.26	110.91	111.48	151.36	1/(1)
Spain	79.15	69.67	82.43	75.50	189.64	2/(3)
Italy	115.54	76.71	60.81	45.67	283.84	3/(2)
United Kingdom	56.26	59.77	n/a	n/a	146.34	4/(5)
BENELUX	52.66	57.24	45.67	43.34	78.88	5/(6)
Germany	29.98	32.54	29.67	31.56	87.23	6/(8)
Austria & CEE	30.02	30.52	29.34	28.29	81.35	7/(7)
Nordics	25.61	27.63	20.79	18.96	46.10	8/(9)
Greece	70.46	53.69	15.19	9.86	115.78	9/(4)
Portugal	15.15	12.23	7.91	6.55	42.26	10/(10)
Ireland	6.99	9.34	7.72	5.22	55.59	11/(11)
Cyprus	5.80	3.14	1.37	1.08	23.99	12/(12)
Malta	0.45	0.57	0.55	0.39	0.72	13/(13)
EU	583.99	467.65	391.41	357.38	1,210.89	

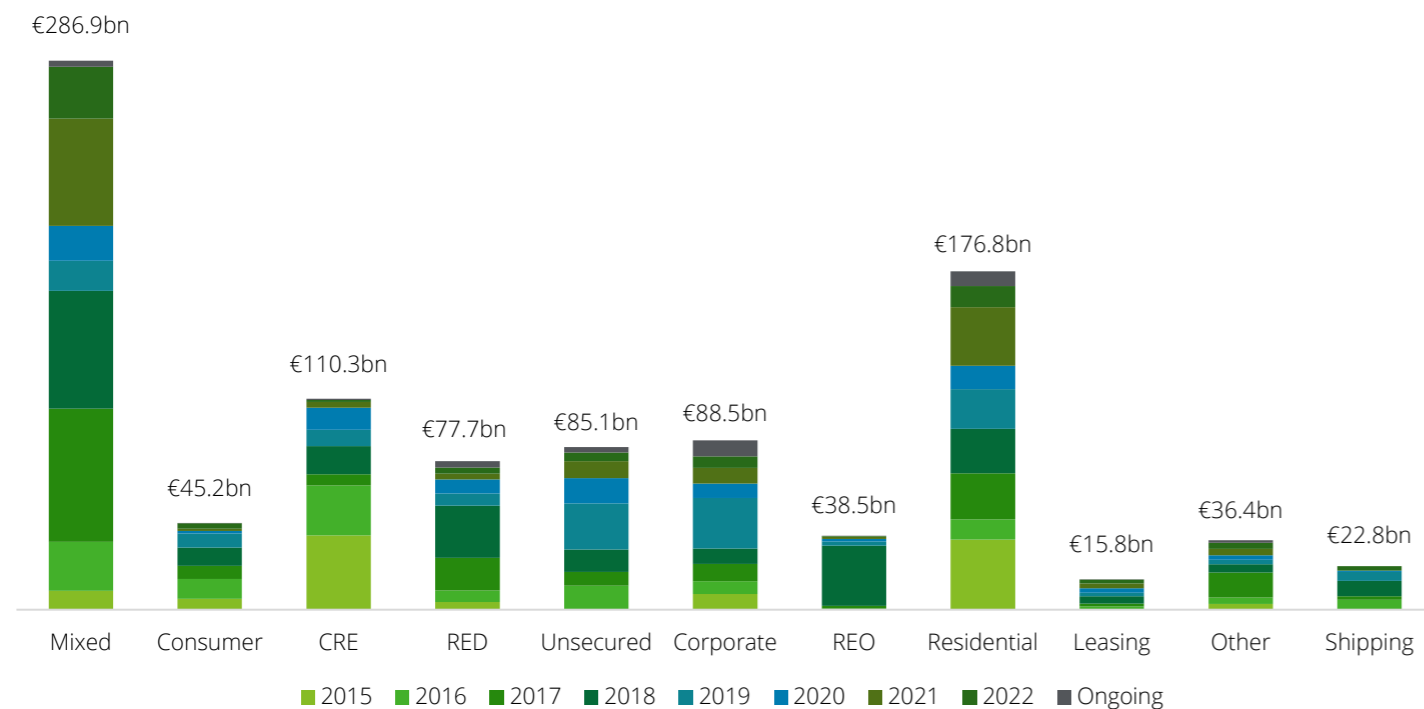
Source: EBA Q4 2022 Risk dashboard. Covers EEA members only and does not track UK NPL volumes since the end of 4Q20 (see page 61 for UK data).

Outlook for loan portfolio transactions

Continued regulatory changes and stricter monitoring from regulators are widely expected to require banks to more proactively manage their balance sheets, and importantly RWAs and liquidity levels, which may drive transaction activity across the continent in the coming years. Banks are then expected not only to continue to sell NPL exposures but also to divest under-performing and other non-core exposures on a more proactive approach.

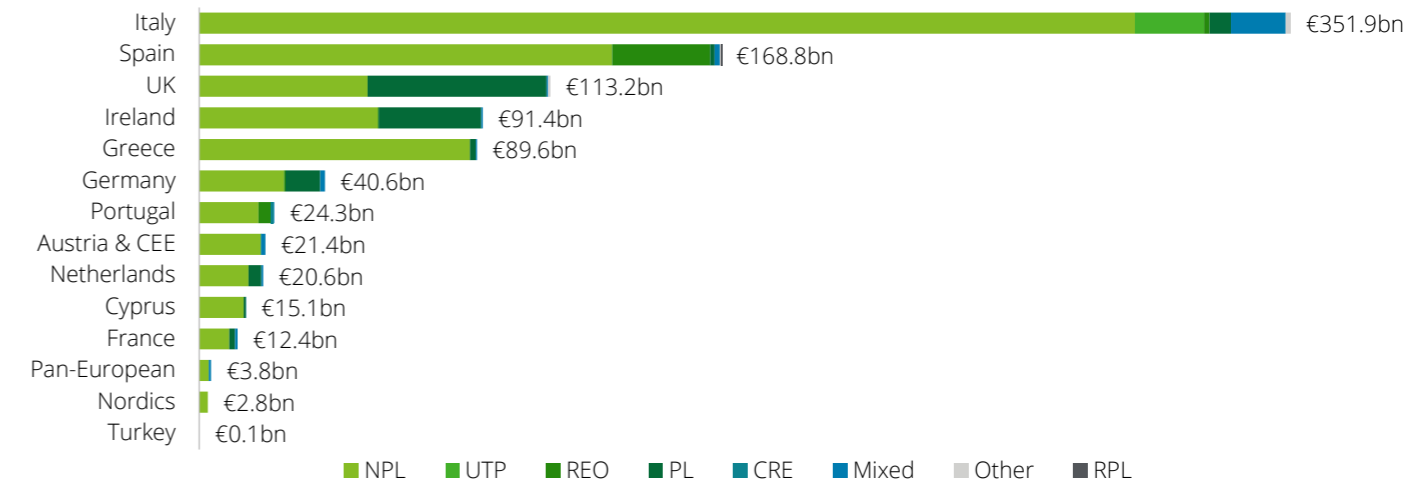
The levels of historical portfolio sales in the primary market over the last 5+ years (~€585bn since – and including – 2018) are likely to see a significant ripple effect in the secondary market, as debt funds come to the end of their harvest periods and look to unload rump exposures which have not yet been fully worked out or, alternatively where, in light of a more challenging environment, funds fail to meet business plan and seek an early exit.

Figure 37: Activity by Asset Type since 2015 - Europe



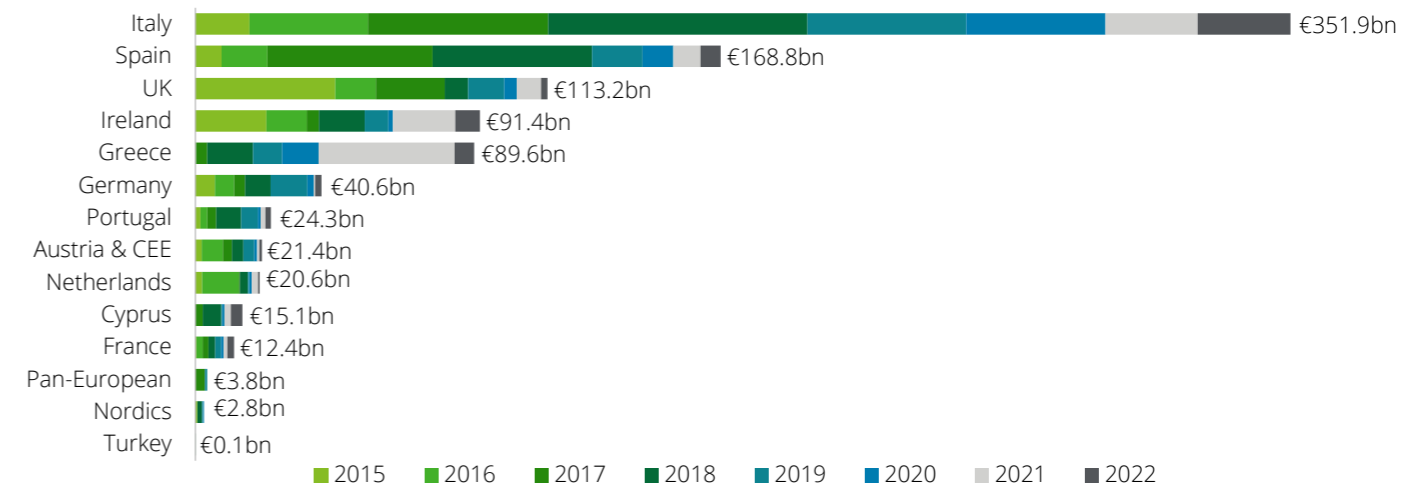
Source: Deloitte analysis based on publicly available information - as at 4Q22

Figure 38: Completed Deals by Country since 2015 (by type)



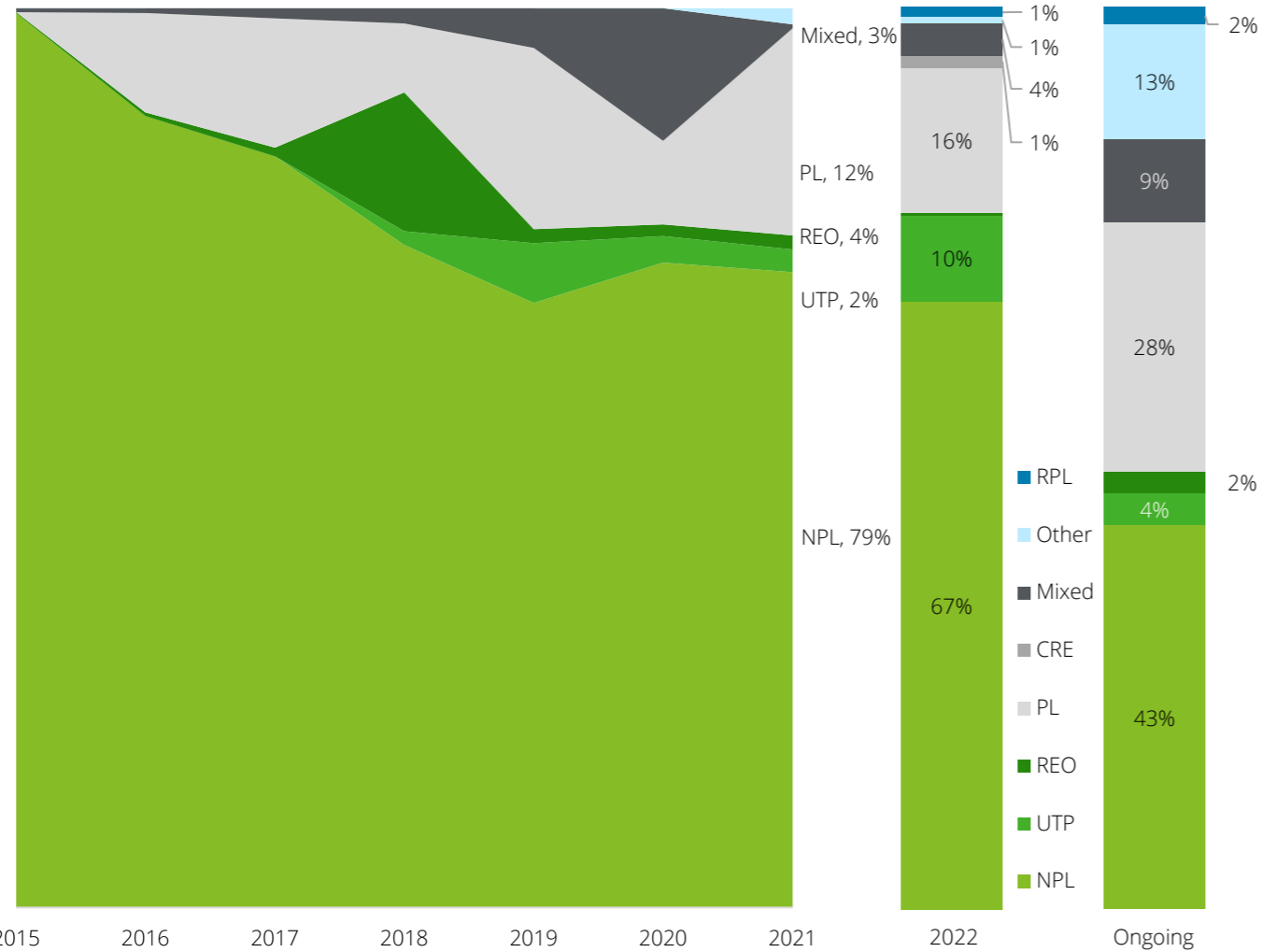
Source: Deloitte analysis based on publicly available information

Figure 39: Completed Deals by Country since 2015 (by year)



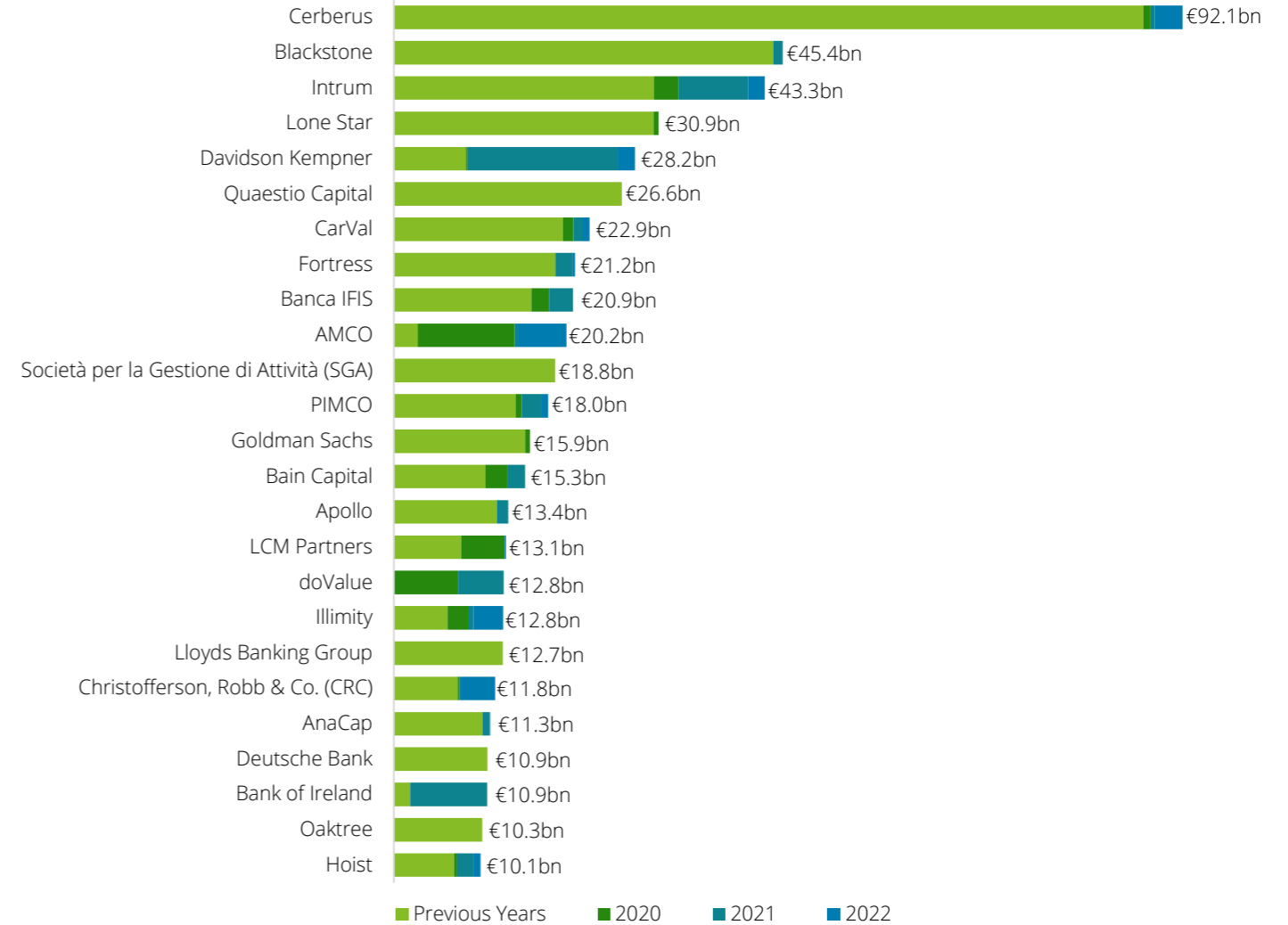
Source: Deloitte analysis based on publicly available information

Figure 40: Loan sale activity by portfolio type since 2015 - Europe



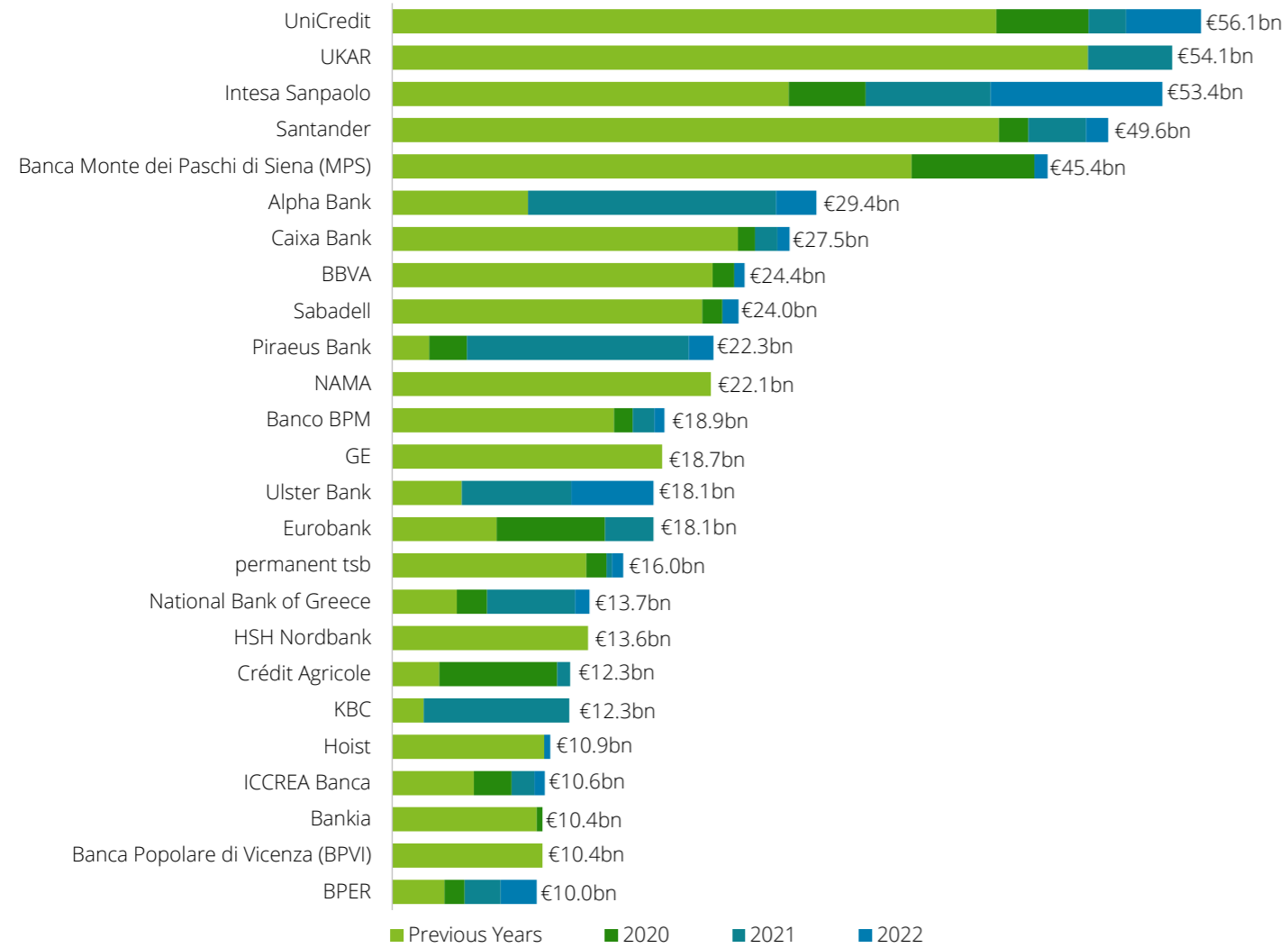
Source: Deloitte analysis based on publicly available information - as at 4Q22

Figure 41: Top Buyers since 2015 - Europe



Source: Deloitte analysis based on publicly available information

Figure 42: Top Sellers since 2015 - Europe



Source: Deloitte analysis based on publicly available information



Active Loan Portfolio Markets

United Kingdom



Macroeconomic overview

Despite earlier concerns around a prolonged downturn, latest forecasts from the IMF (23 May 2023) suggest that the UK will avoid a recession this year (just), growing by a lacklustre 0.4% in 2023, with inflation falling to around 5% by the end of the year. However, the outlook remains weak, with the IMF forecasting only modest growth of 1% in 2024 and 2% in 2025/26. Moreover, real household disposable incomes are anticipated to fall by a total of 5.7% for the two-year period ending April 2024, (inflation is anticipated to take longer to come down than previously forecast) with real living standards returning to their 2019 levels only by 2028²⁰.

UK banks started the pandemic well capitalised and with sufficient liquidity buffers. NPL volumes in the UK remained low throughout the pandemic at around 1.9% classified as Stage 3, decreasing to 1.7% by 4Q22²¹, reflecting successful business support measures introduced, including loan moratoria and various government backed lending schemes. As of 31 December 2022, businesses had drawn 1.6 million facilities under these schemes totalling £77 billion, of which 2.1% had been subject to a default²².

There has been an uptick in the volume of Stage 2 assets; despite little change in observed credit performance, downgrades in HPI expectations have led to worsened future default expectations, pushing more loans over the 'significant increase in credit risk' probability of default ("PD") thresholds and into Stage 2, reaching 12% as at 4Q22 vs 11% as at 3Q22²³.

²⁰ EIU

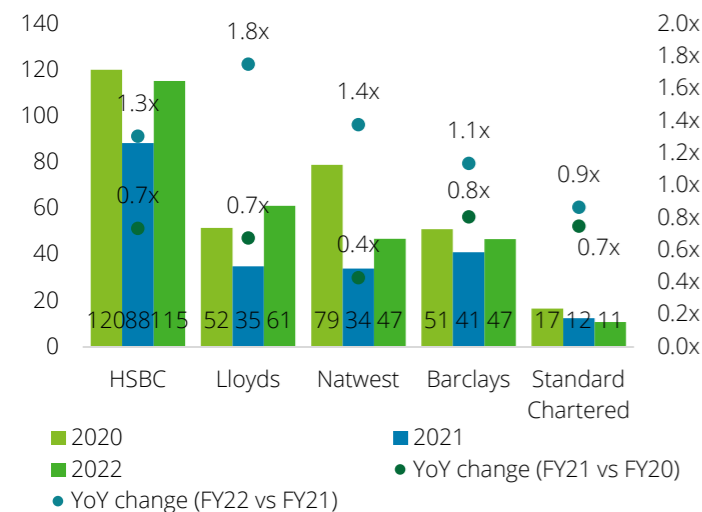
²¹ Deloitte IFRS 9 | 4Q22 results update

²² Department for Business, Energy and Industrial Strategy

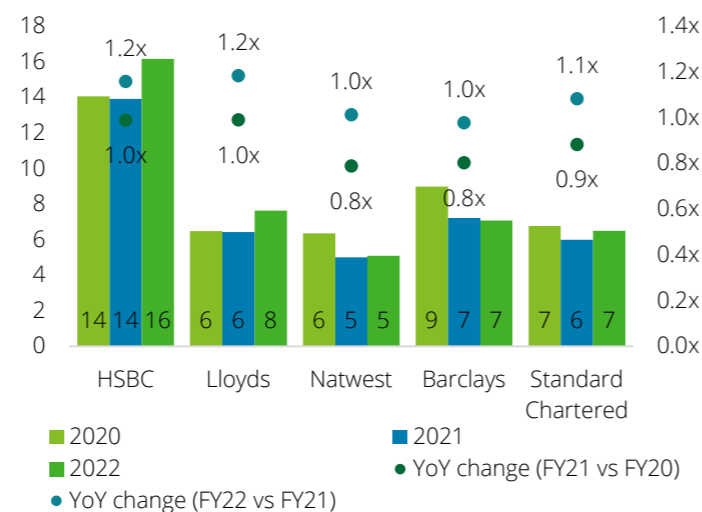
²³ Deloitte IFRS 9 | 4Q22 results update

Figure 43: Top 5 UK Banks IFRS staging evolution 2020-2022

Top 5 UK Banks Stage 2 Loans (£bn)



Top 5 UK Banks Stage 3 Loans (£bn)



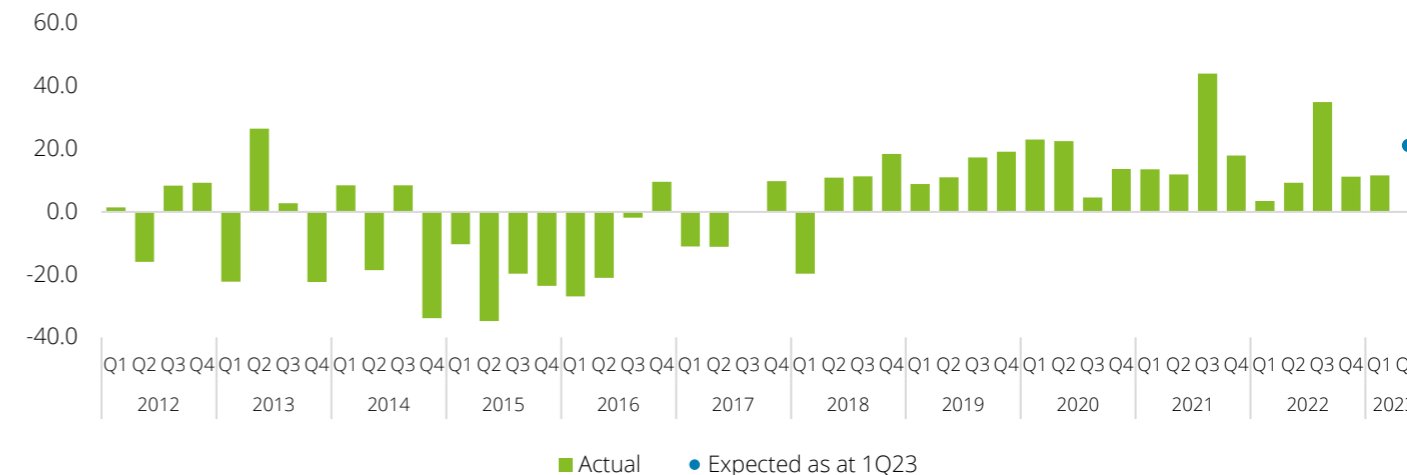
Source: Deloitte analysis of banks' annual reports

The Bank of England's Q1 indicative Credit Conditions Survey, published on 13 April 2023, provided an indication that lenders on balance expect default rates to increase during Q2, with those responding to the survey noting:

- Default rates on secured loans to households increased in 1Q23, and were expected to increase further in 2Q23, with losses given default ("LGD") on secured loans also increased in 1Q23 and were expected to increase further in 2Q23.
- Default rates for total unsecured lending (including credit cards) increased in 1Q23 and were expected to increase further in 2Q23.
- Default rates on loans to both small and medium-sized corporates increased in 1Q23 and were expected to increase further in 2Q23, while remaining unchanged for large businesses. LGDs were unchanged for small businesses, but slightly increased for medium and large businesses in 1Q23. LGDs on loans to small and large corporates were expected to remain unchanged in 2Q23, and to increase slightly for medium-sized businesses.

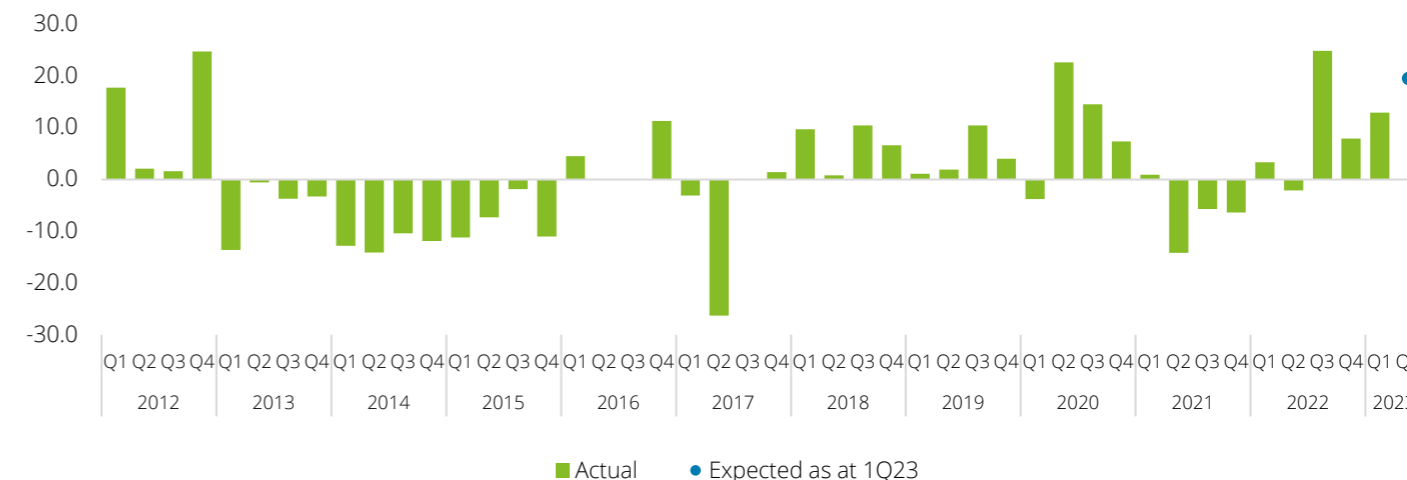
Analysts will need to wait until quarterly results are published to see if and how these more cautious predictions are reflected.

Figure 44: Net percentage balance for changes in default rates for UK small-sized businesses



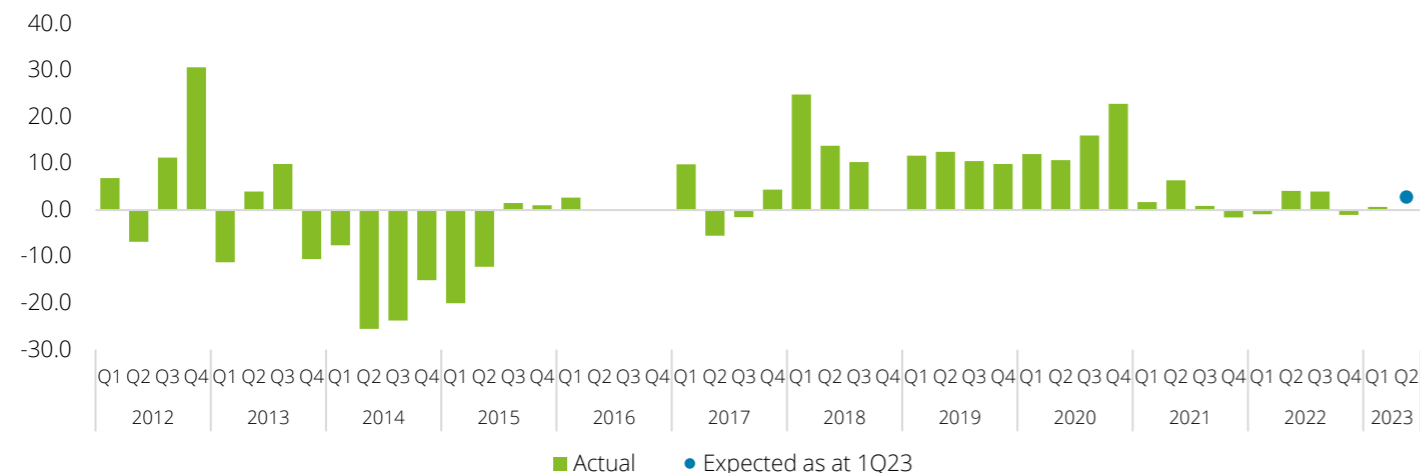
Source: BoE Credit condition survey 1Q23 – A positive balance indicates an increase in the default rate

Figure 45: Net percentage balance for changes in default rates for UK medium-sized businesses



Source: BoE Credit condition survey 1Q23 – A positive balance indicates an increase in the default rate

Figure 46: Net percentage balance for changes in default rates for UK large-sized private non-financial corporates



Source: BoE Credit condition survey 1Q23 – A positive balance indicates an increase in the default rate

Portfolio market – recent deals

Consistent with global trends, transaction activity slowed following the initial outbreak of the pandemic, as previously planned major deals were put on hold, but re-commenced in 2021 with a number of transactions closed, however these were predominantly performing mortgage transactions.

Mortgage portfolios continue to be the main asset traded, making up ~70% of total assets traded between 2015 and 2022, and reflecting the disposal of the former Bradford & Bingley (“B&B”) and Northern Rock Asset Management (“NRAM”) residential loan portfolios held by UKAR since the beginning of the GFC. UKAR sold its shares in B&B and NRAM in February 2021 along with their remaining mortgage and loan portfolios to a consortium of Davidson Kempner Capital Management LP (“Davidson Kempner”) and Citibank (“Citi”), marking an end to this chapter of loan portfolio transaction activity.

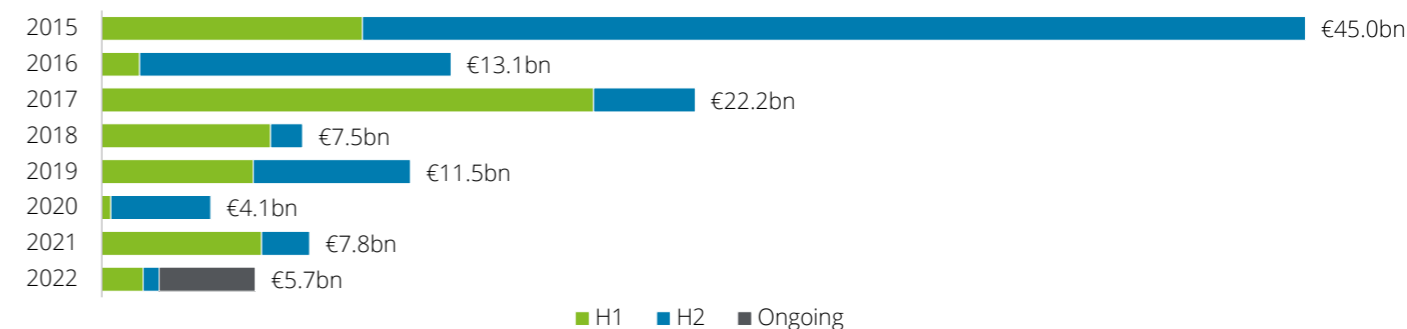
Portfolio transactions in 2022 principally related to the sale of platforms and related serviced portfolios (capital raise or due to fund exits), ~70% of these were in the residential mortgage space (~60% of which were performing) including Masthaven’s Project Genesis sale to Starling Bank (£500m/~ €556m Unpaid Principal Balance (“UPB”).

Future outlook

Notwithstanding modestly improved near-term fiscal projections, compared to forecasts at the end of 2022, owing primarily to a sharp fall in wholesale energy prices, some commentators have noted that fundamental challenges to the UK economy persist²⁴, which are likely to constrain growth over the next five years and impact on banks’ asset quality metrics.

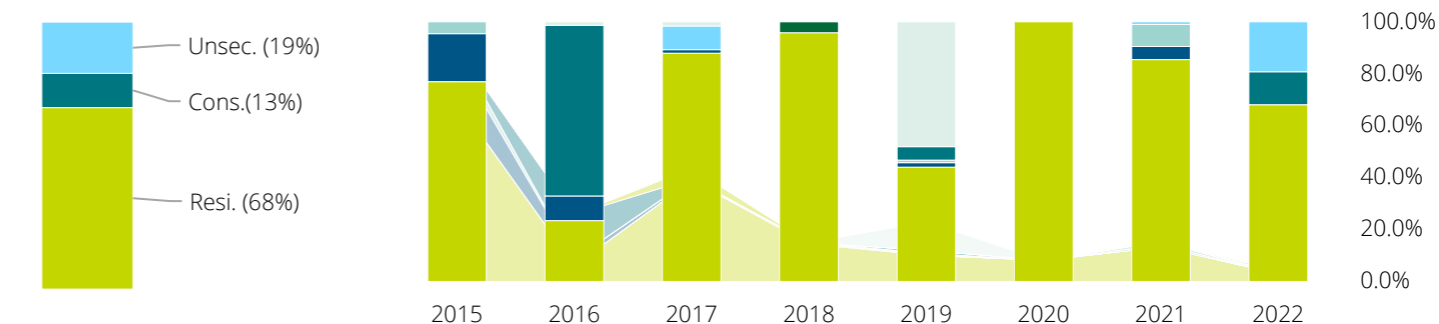
In the loan portfolio market, to meet capital adequacy requirements, as new NPLs accumulate, banks may seek to periodically off load, high volume, smaller ticket SME NPL portfolios (including Coronavirus Business Interruption Support Loan Scheme (“CBILS”) portfolios where these fall into default).

Figure 47: Activity by year - UK



Source: Deloitte analysis based on publicly available information - as at 4Q22

Figure 48: Activity by asset class 2022 - UK



Source: Deloitte analysis based on publicly available information

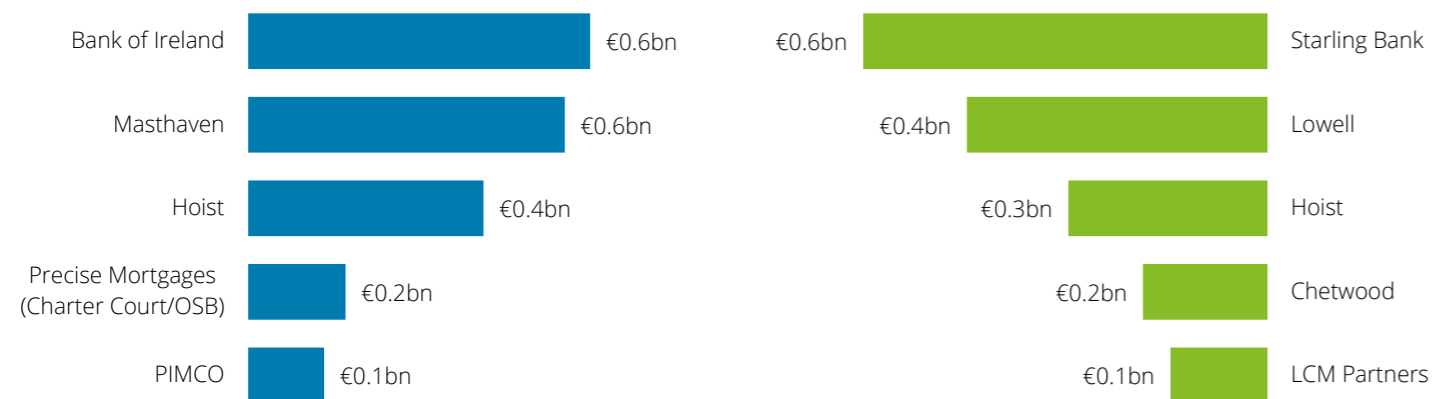
²⁴ As at 16th March 2023: UK budget tinkers at the margins | Events | EIU

Table 2: Completed transactions in 2022 - UK

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Confidential	Unsecured	Mixed	Hoist	Lowell	413
Confidential	Consumer	NPL	Confidential	Hoist	274
Project Genesis	Residential	PL	Masthaven	Starling Bank	556
Project Domus	Residential	PL	PIMCO	LCM Partners	133
Confidential	Residential	RPL	Bank of Ireland	Securitisation	600
Confidential	Residential	PL	Precise Mortgages (Charter Court/OSB)	Chetwood	171

Source: Deloitte analysis based on publicly available information

Figure 49: Top Sellers and Buyers in 2022 - UK



Source: Deloitte analysis based on publicly available information

Ireland



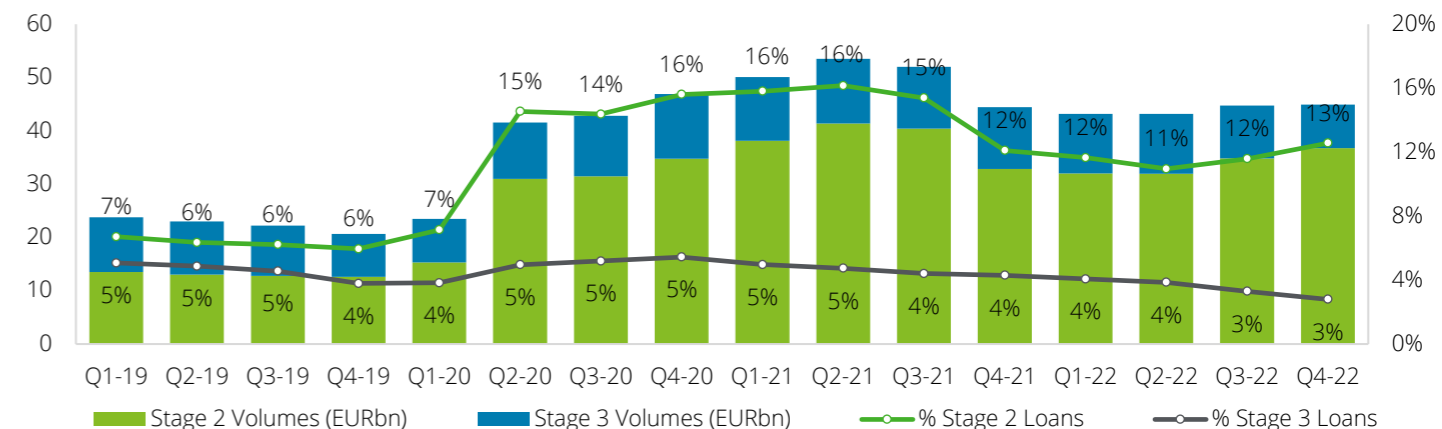
Macroeconomic overview

Real terms Irish GDP grew 12.2% in 2022, mainly reflecting the balance-sheet movements of large corporations, including large multinationals. Private consumption growth, considered a more reliable indicator of domestic activity, was estimated at 6.8% in 2022, as pent-up demand was released following the easing of COVID related lockdowns in 2021.

Growth is forecast to slow sharply in 2023 to 1.0%, as high energy costs and rising interest rates weigh domestic demand and business activity. Private consumption growth is forecast at 1.8% in 2024 and to average 3.2% annually from 2025 - 2027²⁵, with overall GDP expected to grow by 6.2% in 2023, although again this is skewed by effect of the multinational sector on GDP figures. Growth is expected to moderate to 3.9% in 2024 before stabilising at around 2.9% annually from 2025. These forecasts are subject to additional uncertainty given the volatility of the multinational sector.

Considering its very high levels of NPLs in the aftermath of the GFC, Ireland has made extraordinary progress in the past 8 years to bring this back under control, with the percentage of loans classified as Stage 3 reaching 2.8% as at 4Q22, primarily driven by a resumption of banks' NPE reduction programmes, along with government sponsored financial support measures and loan moratoria which slowed the creation of new NPLs during the pandemic. However, in absolute terms the volume of Stage 3 loans as at 4Q22 were €8.2bn compared to €8.0bn²⁶ as at 4Q19.

Figure 50: IFRS staging evolution 2019 - 2022 - Ireland



Source: EBA risk dashboard 4Q22

²⁵ EIU as at March 2023

²⁶ EBA

Portfolio market – recent deals

In terms of asset classes traded, while initial activity (post GFC) was focused on non-performing CRE portfolios, recent sales have mostly been of performing books in the residential/ corporate sectors. After nearly a decade of activity, pillar banks have mostly worked through their original NPL stocks and recent deal flow has been driven primarily by bank deleveraging/ strategic retrenchment, including Ulster Bank’s €5.7bn sale to AIB (Project Tasman).

In the NPL space, AIB launched two sales during 2022 with the confidential sale of a smaller non-performing mixed book (€400 million) and the ongoing sale of its NPL CRE book (Project Sycamore - €700 million). AIB has been the main seller on NPLs during the past two years, including €1.26 billion in 2021, with buyers including Mars Capital (Arrow), Apollo, Ellington Management and Morgan Stanley.

Future outlook

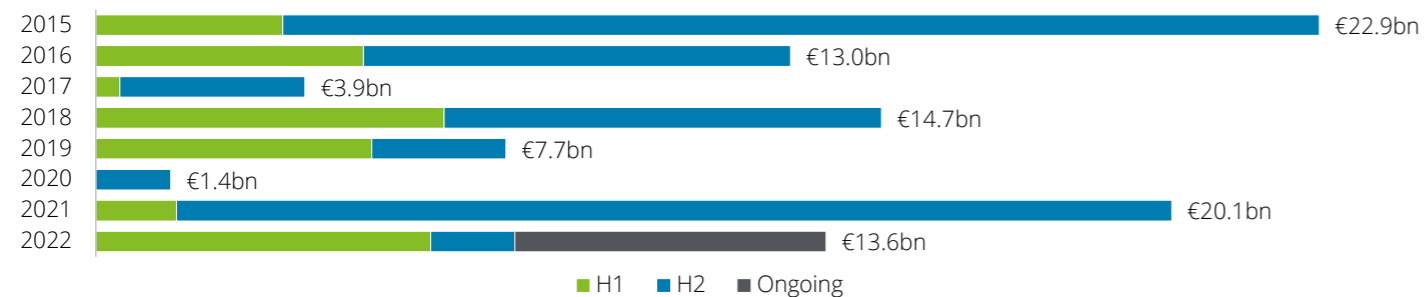
Historical NPL stocks built up in the GFC and its aftermath are now largely exhausted following a decade long era of deleveraging by the pillar banks.

In the mortgage market, banks have also largely exited non-core portfolios. Rising interest rates along with increasingly squeezed real terms incomes, and/or downward HPI pressure may result in higher defaults.

In the SME space, corporate insolvencies increased by 29% year on year, reflecting a shift towards pre-pandemic levels of insolvency activity given artificially low levels in 2020 and 2021²⁷. Given the economic headwinds, combined with higher inflation, energy costs and interest rates we anticipate an increase in both IFRS 9 Stage 2 and 3 loan volumes.

The secondary market in Ireland is currently busier than the UK reflecting the last 5 years’ significant primary market deal flow - over €85bn of loan sales (both performing and non-performing) since 2015 across all asset classes but predominantly CRE (c.€34 billion) and Residential (c.€39 billion).

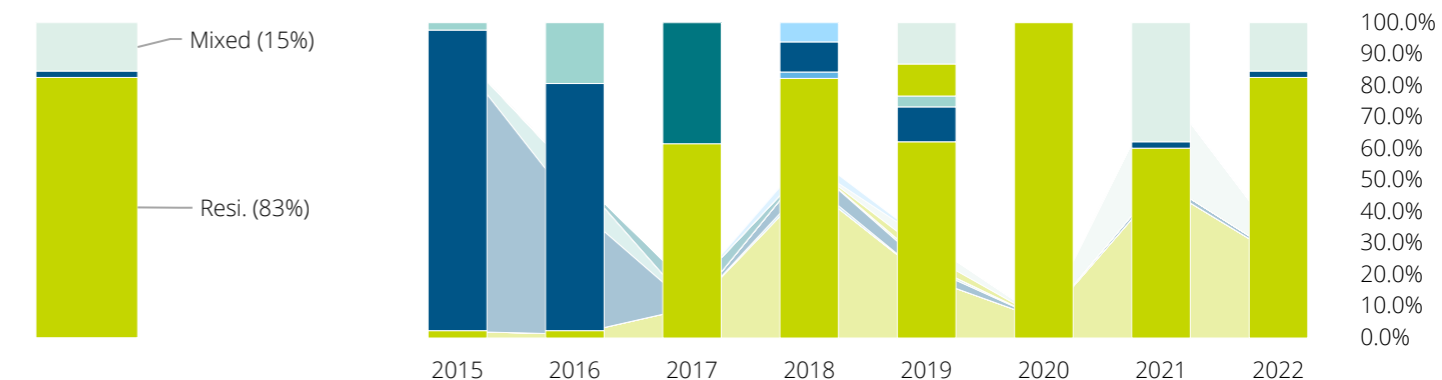
Figure 51: Activity by year - Ireland



Source: Deloitte analysis based on publicly available information - as at 4Q22

²⁷ Deloitte Corporate Insolvency Statistics 2022

Figure 52: Activity by asset class 2022 - Ireland



Source: Deloitte analysis based on publicly available information

Table 3: Completed transactions in 2022 - Ireland

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Project Robin	CRE	PL	Goldman Sachs	Confidential	160
Project Tasman	Residential	PL	Ulster Bank	Allied Irish Bank (AIB)	5,700
Confidential	Mixed	NPL	Allied Irish Bank (AIB)	Confidential	400
Glenbeigh 4	Residential	PL	Permanent TSB	PIMCO	770
Confidential	Mixed	NPL	Bank of Ireland	CarVal	800

Source: Deloitte analysis based on publicly available information

Figure 53: Top Sellers and Buyers in 2022 - Ireland



Source: Deloitte analysis based on publicly available information (excludes confidential)

Spain

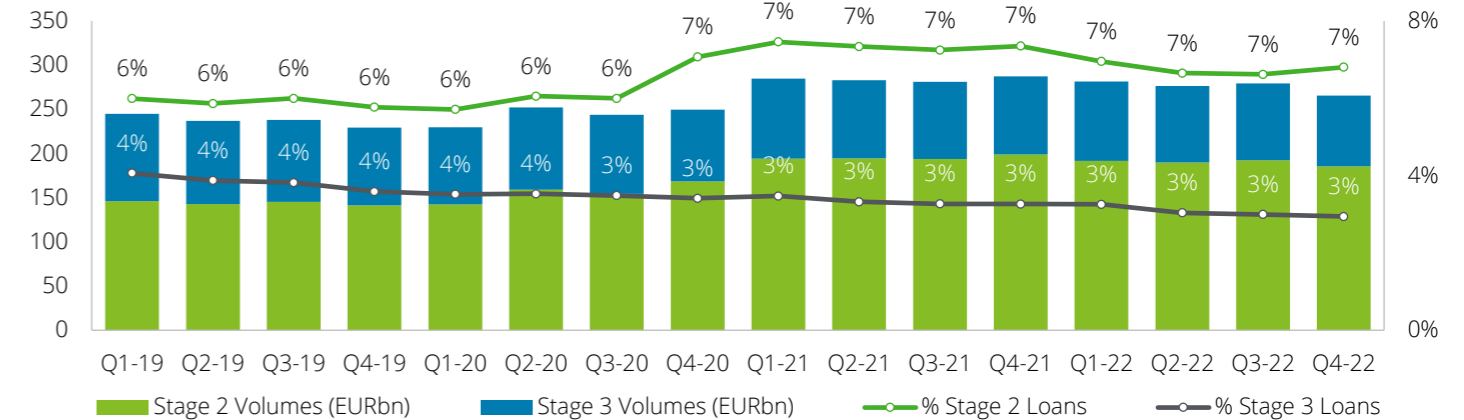


Macroeconomic overview

Spanish GDP fell by 11.3% in 2020, but recovered in 2021 and 2022, driven, inter alia, by savings built up during the pandemic and higher consumer spending as the economy opened up again, with GDP growth of 5.5% and 4.6% in 2021 and 2022, respectively. However, the subsequent more difficult economic environment and inflationary pressure, from early 2022, has caused a significant slowdown in the Spanish economy with GDP expected to increase at a modest 1.3% in 2023 and forecasts showing only sluggish growth in the near term thereafter.

Despite a challenging economic environment, Spanish Banks continue to have broadly stable asset quality metrics, with the percentage of loans classified as Stage 3 falling to 2.9% as at 4Q22. In absolute terms, loans classified as Stage 3 reduced by ~€8bn in 2022 from €88.5bn as at 4Q21 to €80.3bn as at 4Q22.

Figure 54: IFRS staging evolution 2019-2022 - Spain



Source: EBA risk dashboard 4Q22

Portfolio market - recent deals

Non-core deal activity effectively came to a halt following the initial outbreak of the pandemic in 2020. Since then, Spanish banks have been slowly but steadily resuming their deleveraging programs although volumes traded are still well below 2019 levels (see Figure below).

During 2022, transactions brought to the market were highly concentrated in the “bread and butter” of the NPL market, where unsecured trades and residential mortgage portfolios have exceeded €3.5bn and €2.0bn, respectively, reflecting investor appetite, generally

favourable financing conditions, and - for secured trades - the ongoing resilience of the housing market.

Overall deal activity in 2022 was €6.5bn, three quarters the level observed in 2021, (and ~€7.8bn ongoing as at 4Q22) reflecting lower NPLs generally (reduced pressure to sell) as well as higher interest rates which have widened price expectations, particularly in terms of residential mortgage trades. Residential mortgage trades in 2022 accounted for just 15% of deal flow compared to ~42% in 2020.

Future outlook

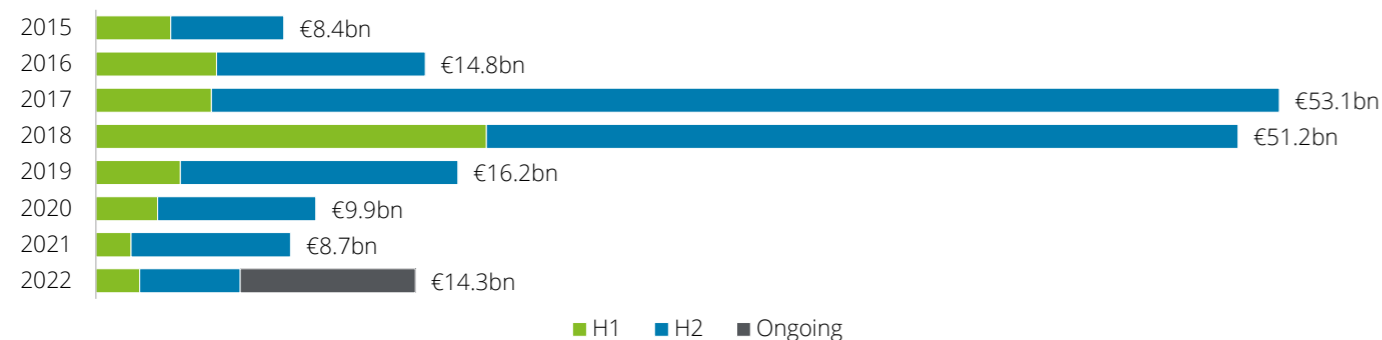
The volume of Stage 3 loans held by Spanish banks totalled ~€80.3bn as at 4Q22²⁸, second to France (~€137bn) and ~19% of total EU stocks. Moreover, Spanish banks have seen an increase in the level of Stage 2 exposures from 5.8% (€141bn) as at 4Q19 to 6.8% (€186bn) as at 4Q22, which may point to future asset quality concerns if the current challenging macroeconomic conditions are prolonged.

As such and while the present uncertain economic outlook may dampen transaction activity in 1H23, regulatory pressure, and the need to proactively manage RWAs could be the catalyst for increased market activity in the second half of 2023.

In the meantime, it is likely that the market will continue to bring some opportunities for investors mainly focused on unsecured, SMEs secured and a limited number of residential mortgage portfolios.

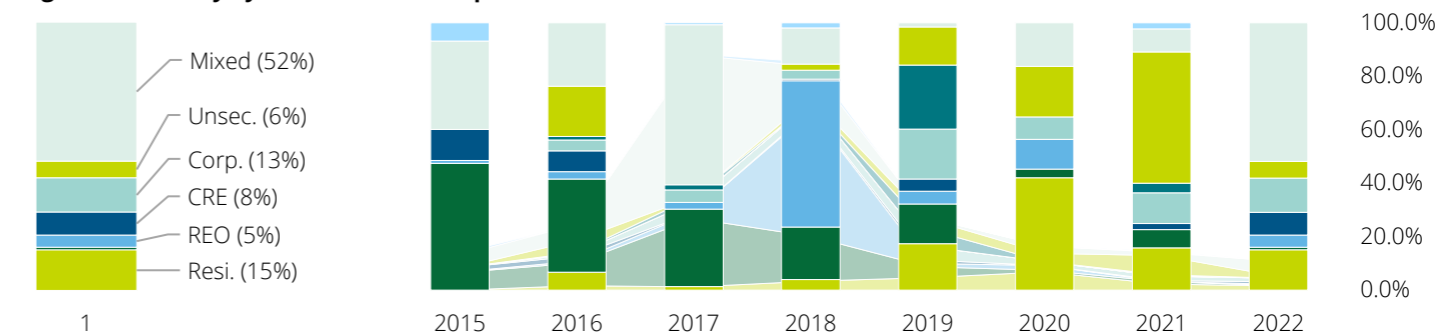
In addition to these portfolios, the current environment could lead sellers to trade (i) single-name exposures with a repositioning/restructuring angle and (ii) reperforming/sub-performing books which are more burdensome to manage, including as a result of regulatory/legal requirements (i.e., legislation delaying debt acceleration, and thus, legal enforcement to 12-15 months of default), through operational and tax efficient structures in an attempt to maximize pricing.

Figure 55: Activity by year - Spain



Source: Deloitte analysis based on publicly available information - as at 4Q22

Figure 56: Activity by asset class 2022 - Spain



Source: Deloitte analysis based on publicly available information

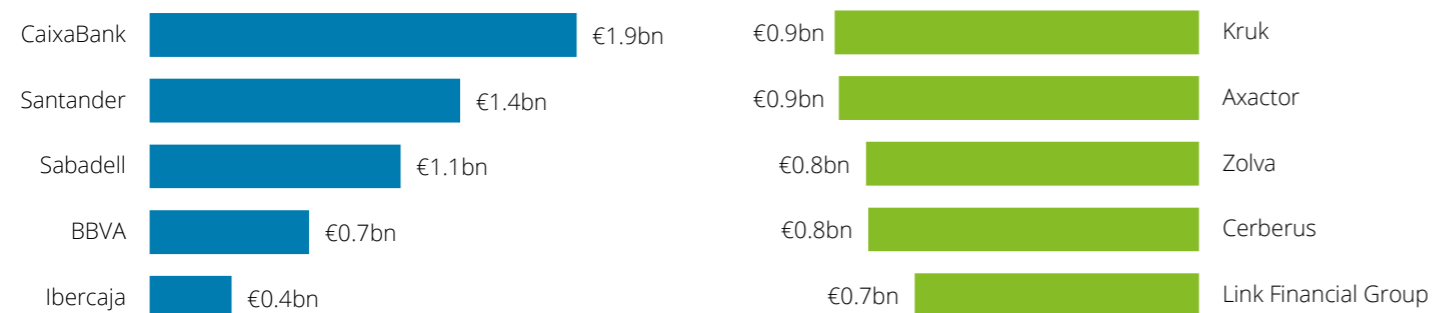
Table 4: Completed transactions in 2022 (top 10 transactions by size) - Spain

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Project Ordesa	Mixed	NPL	CaixaBank	Axactor; Kruk	1,100
Project Austro	Mixed	NPL	Sabadell	Zolva	832
Project Yellowstone	Corporate	NPL	CaixaBank	Cerberus	826
Project Neila	Mixed	NPL	BBVA	Link Financial Group; Kruk	720
Project Macondo	Residential	RPL	Santander	Morgan Stanley; Ellington Management	700
Project Celtic Park	Mixed	NPL	Santander	Axactor; Link Financial Group	700

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Bubal	Unsecured	NPL	Ibercaja	Confidential	370
Project Cora	CRE	NPL	Sabadell	Hoist	300
Leónidas	REO	n/a	Leónidas	Confidential	300
Project Elcano	Residential	NPL	Unión de Créditos Inmobiliarios	Hoist	280

Source: Deloitte analysis based on publicly available information (excludes confidential)

Figure 57: Top Sellers and Buyers in 2022 - Spain



Source: Deloitte analysis based on publicly available information (excludes confidential deals/ for consortia trades we have assumed pro-rata splits)

Portugal



Macroeconomic overview

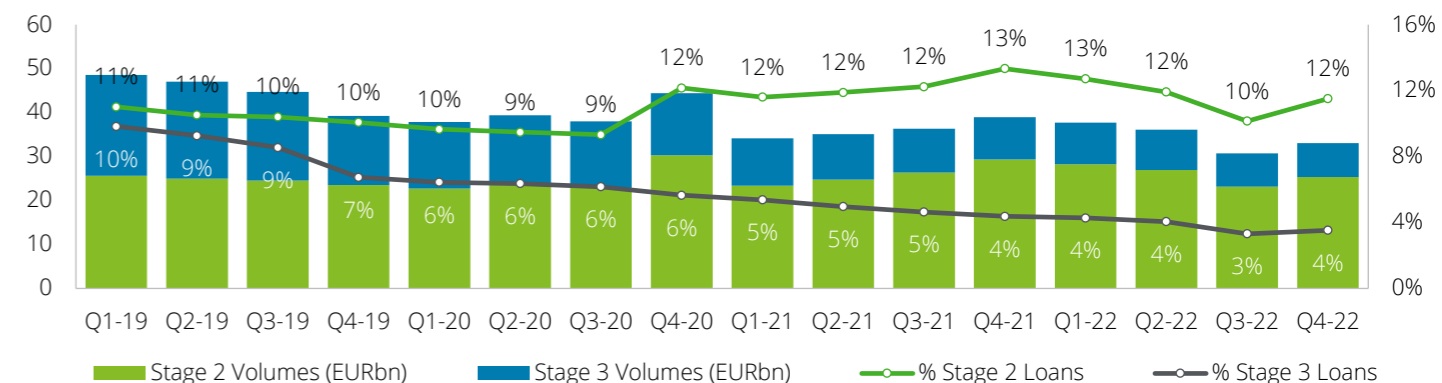
Real terms GDP recovered to pre-pandemic levels during 2022, growing by 6.7%, one of the fastest rates of increase in the EU, spurred by an increase in private consumption and a continued recovery of the tourism sector. Nevertheless, tighter monetary policy conditions, constrained external demand and high domestic inflation are anticipated to act as a drag anchor in 2023 with real GDP growth forecast to slow to 1.1% in 2023, before returning to an expected average of c.1.9% p.a. between 2024 and 2027.

A key factor in Portugal's economic recovery has been its openness to international trade and investment. Portugal has a highly skilled and educated workforce, making it an attractive destination for foreign investors, with the Portuguese government having implemented a range of policies to encourage foreign domestic investment.

Portugal's harmonised index of consumer prices slowed to 8.6% Y.O.Y. in January 2023, compared with 9.8% in December 2022, as energy price rises eased but were offset by increased food prices. Core inflation remains high, putting a squeeze on household budgets, with the average inflation for 2022 being 8.1%, but is expected to reduce to 5.6% in 2023 and to stabilize around 2% in the 2024-27 period.

The Portuguese banking system is highly concentrated, with the top 6 banks holding the majority of NPLs stocks. Encouraged by regulatory authorities, Portuguese banks have been steadily reducing their NPL stocks, as a result the percentage of loans classified as Stage 3 has fallen to 3.5% as at 4Q22 from ~10% as at 1Q19. Banks are implementing measures to better manage future NPLs and assist with the early identification of repayment difficulties, including regular credit assessments and implementation of suitable recovery strategies, to avoid delayed recognition of credit losses and deterioration in asset quality.

Figure 58: IFRS staging evolution 2019-2022 - Portugal



Source: EBA risk dashboard 4Q22

Portfolio market – recent deals

During 2022, the main Portuguese banks continued to drive their deleveraging agendas, with ~€1.8bn of portfolio sales transacted in the year (and a further ~€400m ongoing at the year-end) albeit this remains well below pre-pandemic levels.

Considering activity by asset class, recent activity has focused on real estate owned (“REO”), for instance, Project Crow and Project Connect, and mixed assets portfolios, such as Project Citron and Alqueva.

Investor appetite for NPLs remains strong. However, some transactions were not concluded amid more challenging economic conditions in 2022.

Future outlook

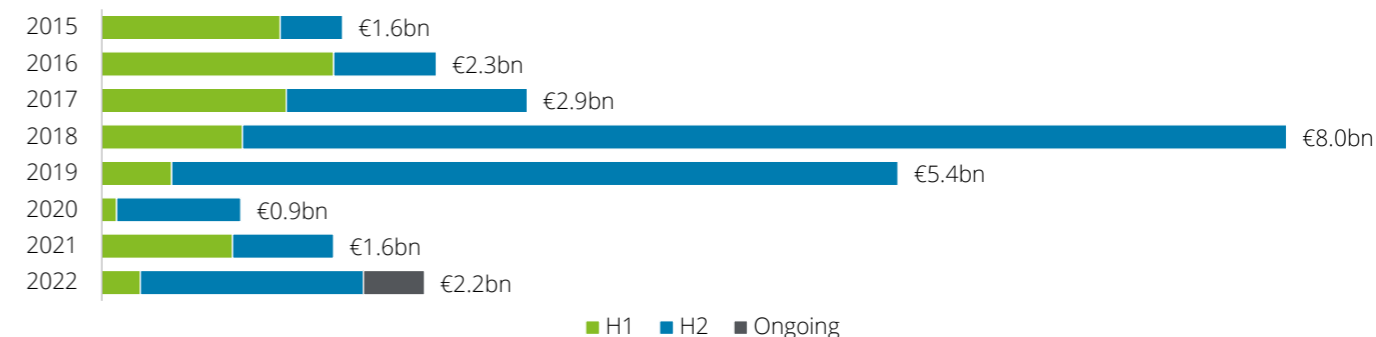
The NPL situation is currently stable, on the back of liquidity provided through COVID support schemes and other pre-agreed contractual drawdowns, and (for the present at least) there are no signs of a major change in the short term. However, borrowers may face repayment issues once this extra liquidity has dried up and the scheduled interest rates contractual review is reflected in the credit instalments. With real terms household incomes squeezed by higher interest rates and inflation, this could be particularly problematic for the retail sector in a rising interest rate environment given the high proportion of loans with variable interest rates. Despite a move towards fixed and mixed rate loans, around 90% of outstanding mortgages are linked to floating rates²⁹.

On the corporate side, there are some exposures in certain sectors which could become stressed over the coming months, namely construction and real estate development. Energy intensive sectors, such as manufacturing and transportation, could face severe issues if energy prices remain high and volatile over the course of 2023.

The regulatory framework has encouraged banks to sell NPLs while relatively efficient legal processes have made collections and enforcement comparatively straightforward. In this context, banks will likely continue to bring NPL portfolios to market under the pressure from the Bank of Portugal to comply with the asset quality target, with a focus on mid-sized portfolios, single names and corporate portfolios, and some freshly defaulted granular portfolios.

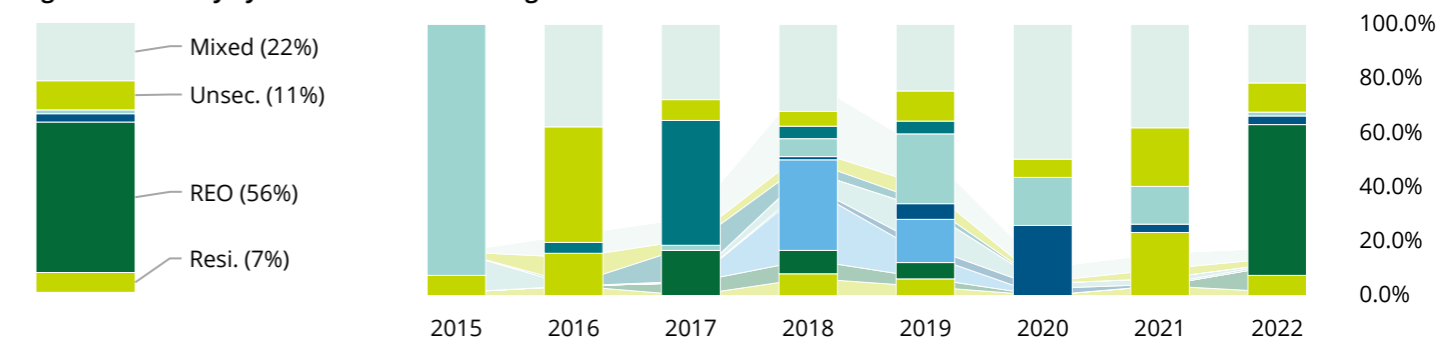
²⁹ Banco de Portugal

Figure 59: Activity by year - Portugal



Source: Deloitte analysis based on publicly available information - as at 4Q22

Figure 60: Activity by asset class 2022 - Portugal



Source: Deloitte analysis based on publicly available information

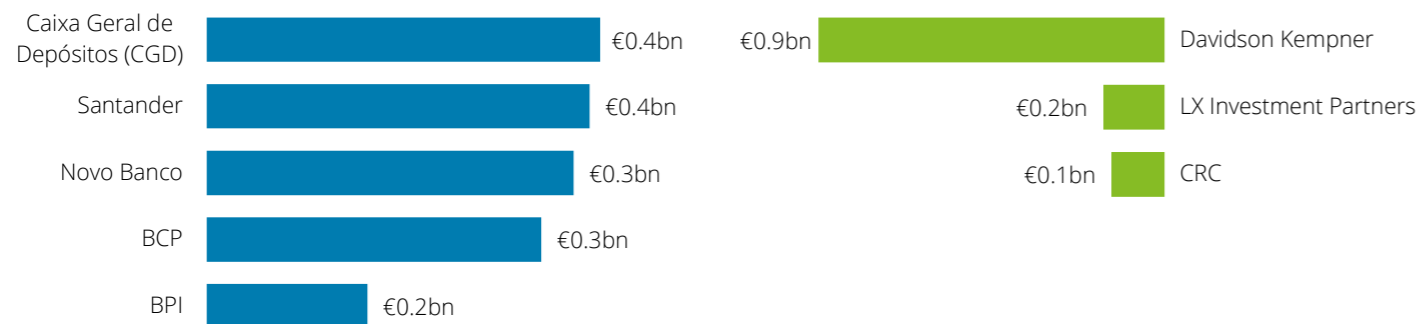
Table 5: Completed transactions in 2022 - Portugal

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Project Crow	CRE	REO	Joint Seller	Davidson Kempner	850
Project Connect	RED	REO	Novo Banco	Confidential	130
Pool 56	Secured	NPL	Santander	Confidential	55

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Pool 57	Unsecured	NPL	Santander	Confidential	90
Project Marão	Corporate	NPL	Caixa Geral de Depósitos	Confidential	25
Project Laser	Mixed	NPL	Bankinter	Confidential	100
Project Citron	Mixed	NPL	BPI	LX Investment Partners	150
Park 1	Unsecured	NPL	BCP	Confidential	100
Alqueva	Mixed	NPL	Montepio	Confidential	130
Project Mercury	Residential	Mixed	Caixa Geral de Depósitos	Christofferson, Robb & Co.	130

Source: Deloitte analysis based on publicly available information

Figure 61: Top Sellers and Buyers in 2022 - Portugal



Source: Deloitte analysis based on publicly available information (excludes confidential deals.) For Project Crow we have allocated on a pro-rata basis across the four main participants being Caixa Geral de Depósitos, Millennium BCP, Novo Banco and Santander. This is for illustrative purposes only.

Italy



Macroeconomic overview

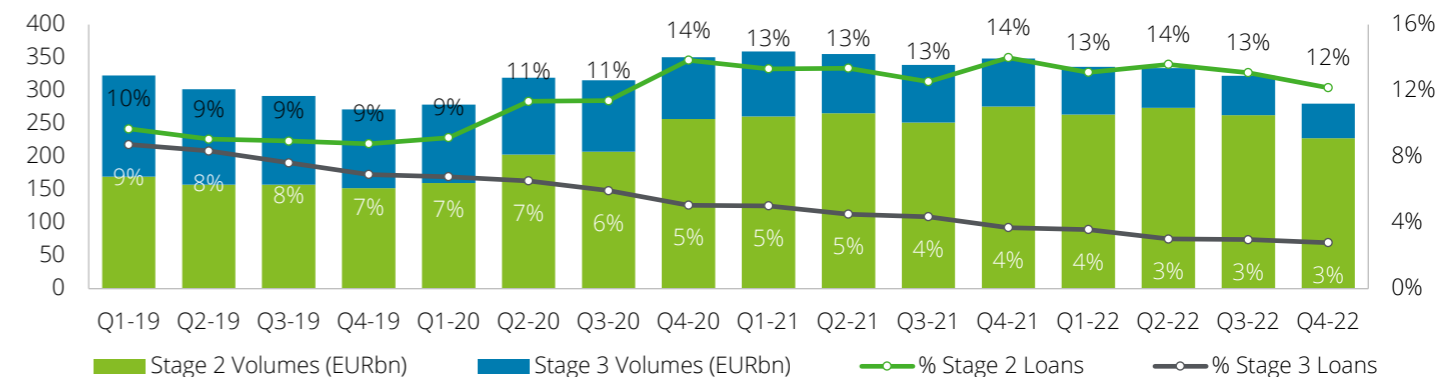
Despite a challenging macroeconomic environment, Italian GDP increased by 3.8% in 2022 over 2021³⁰ (6.7% increase in 2021 over 2020³¹), recovering to pre-pandemic levels in early 2022.

Like other European economies, Italy continues to suffer the effects of high inflation (8.7% in 2022 versus 1.9% in 2021³²), global uncertainty and more restrictive European monetary policies to cool excessive demand pressures. EIU's projections for the Italian economy estimate a significant slowdown in GDP growth to 0.8% in 2023, with inflation falling to 6.8% for 2023 from a peak of 12.6% in November 2022.

Italian banks have benefitted from higher interest rates. At the same time, stocks of loans classified as Stage 3 held by Italian banks fell to ~€52bn as at 4Q22³³, as banks continued their deleveraging processes with the Italian government's GACS or "Garanzia sulla cartolarizzazione delle sofferenze", introduced in 2016 to provide state backed guarantees for qualifying NPE portfolios, proving transformational. GACS expired on June 14 2022, with discussions ongoing between Italy and the EU around its renewal.

At the same time, impairment rates remained extremely low in the period 2020-2021, benefitting from effective government stimulus measures including loan moratoria and various government-backed lending schemes, albeit Stage 2 levels increased sharply and remain elevated compared to 2019.

Figure 62: IFRS staging evolution 2019-2022 - Italy



Source: EBA risk dashboard 4Q22

30 EIU
31 Istat data
32 EIU
33 EBA

Italy saw ~€30bn traded (similar to 2021) with ~€3bn ongoing at 4Q22. This included Unlikely to Pay (“UTP”) transactions with €6.1bn traded in 2022 compared to €3.1bn in 2021. Of this around 34% (€10.3bn) were GACS transactions, prior to the expiry of the scheme (~40%/€11.3bn in 2021).

The secondary NPE market has experienced significant growth over the last years, with €9.5bn in transacted volumes over the last 2 years (2021-2022).

In addition, during 2022, Italian banks with NPE stocks entered into strategic partnerships with leading players in the Italian servicing industry; including:

- In June 2022, UniCredit and Prelios entered into a 6-year servicing agreement for the outsourcing of the management of a portion of actual stock and new inflows of the bank’s UTP loans.
- In December 2022, Gardant and BPER entered into a 10-year servicing agreement involving the management of:
 - part of the NPE residual stock of BPER Banca Group, the disposal of NPL and UTP portfolios to Gardant and AMCO;
 - 90% of the potential future NPL inflows of BPER Banca Group;
 - 50% of the potential new UTP inflows of BPER Banca Group.

Future outlook

Increased IRR expectations from investors and relatively low levels of existing NPE stocks (comprising mainly non-transferable loans), are expected to dampen divestment activity in 2023. Impairments are expected to increase in 2024, as the effects of the current macroeconomic climate feed through, which may point to increased activity in 2024 as banks seek to proactively manage NPE’s.

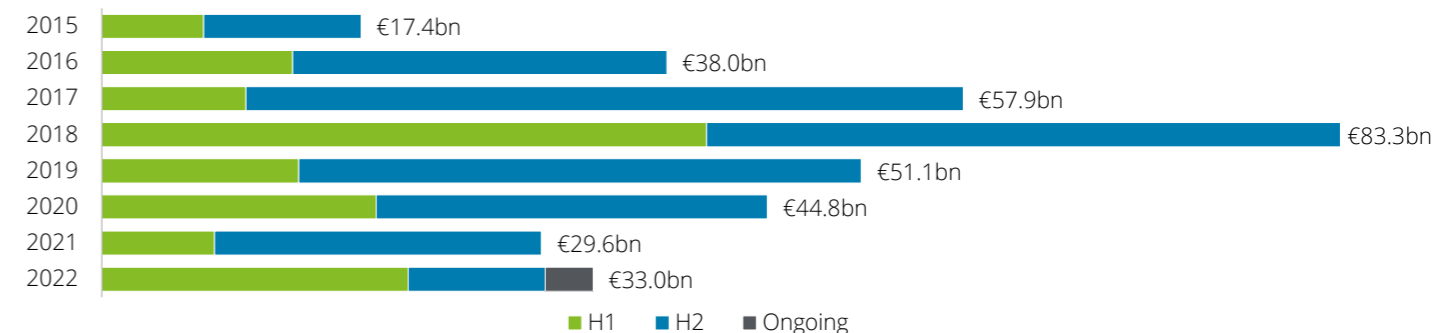
Volumes of NPEs traded in the secondary market have grown in recent years, a trend which is expected to continue in 2023 as funds which were active in the early years reach the end of their investment periods and seek to gear up for new opportunities. The main opportunities in the secondary market will derive from disposals of non-core portfolios and the exit of some investors from the Italian market.

Regarding new trends and opportunities, relatively high levels of Stage 2 loans held by Italian banks (increasing from 9% of total loans at 4Q19 to 12% by 4Q22) may lend themselves to synthetic securitization as a strategy to pursue their de-risking targets and reduce RWAs as well as for qualified investors buying into the structure to generate periodic fee income. We note also a further ~€250bn of publicly guaranteed loans granted in 2020-21 have ended their pre-amortisation periods and are vulnerable to possible demand contractions³⁴.

Finally, considering the strategic partnerships which major banks have implemented in recent years to meet their servicing needs, medium-size banks may now start to investigate similar opportunities to achieve their objectives.

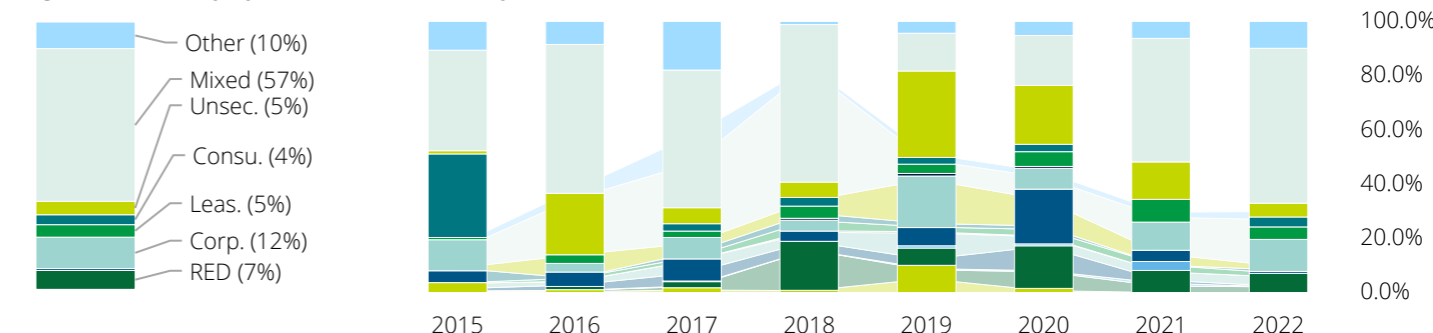
³⁴ Banc d’Italia

Figure 63: Activity by year - Italy



Source: Deloitte analysis based on publicly available information - as at 4Q22

Figure 64: Activity by asset class 2022 - Italy



Source: Deloitte analysis based on publicly available information

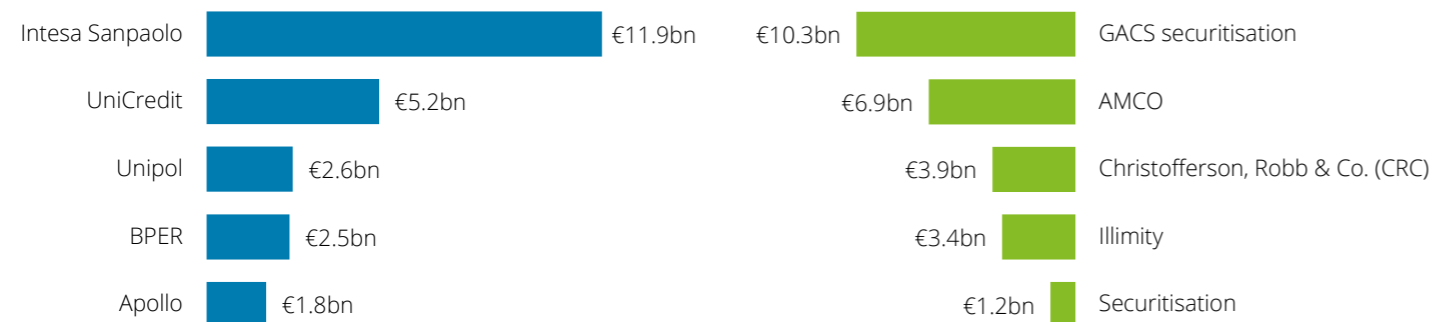
Table 6: Completed transactions in 2022 - Italy (top 10 transactions by size)

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Organa SPV	Mixed	NPL	Intesa San Paolo	GACS securitisation	8,500
Confidential	Corporate	NPL	UnipolReC	AMCO	2,600
Project Panther	Mixed	UTP	UniCredit	Christofferson, Robb & Co. (CRC)	2,000

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Project M3	Other	UTP	Intesa San Paolo	Christofferson, Robb & Co. (CRC)	1,900
Confidential	RED	NPL	Apollo	Illimity	1,800
Confidential	Mixed	NPL	BPER	AMCO	1,500
Confidential	Leasing	NPL	Intesa San Paolo	AMCO	1,400
Confidential	Mixed	NPL	UniCredit	Illimity	1,300
Itaca SPV	Mixed	NPL	UniCredit	GACS securitisation	1,128
Confidential	Mixed	UTP	BPER	Gardant – AMCO	1,000

Source: Deloitte analysis based on publicly available information

Figure 65: Top Sellers and Buyers in 2022 - Italy



Source: Deloitte analysis based on publicly available information (excludes confidential)

Greece



Macroeconomic overview

The Greek economy rebounded swiftly from the effects of the Covid-19 pandemic, with GDP growth in 2021, of ~8%, and ~5% estimated growth in 2022, primarily driven by private consumption and export of services and products.

GDP growth in 2023 is forecast at a more modest 1% before improving to an average rate of ~3.1% in 2024 – 26, with inflation forecast to ease from 9.3% in 2022 to 5% in 2023, and to 1.5% in 2024, bolstered by up to €100bn of combined National & EU funds, including support expected from the Recovery and Resilience Facility (“RRF”) as mitigation against the effect of high energy prices and inflation, programmes which are expected to continue through the end of 2023.

Considering systemic Greek banks tracked by the EBA, the percentage of loans classified as Stage 3 reached single digits (8.5%) during 4Q21³⁵ reflecting the significant progress made by Greek banks in de-risking their balance sheets over the past decade, including through portfolio sales and securitisations under the Hellenic Asset Protection Scheme (“HAPS”), also known as the “Hercules” scheme, which operates in a similar way to Italy’s GACS scheme, and concurrent NPE platform carve-outs.

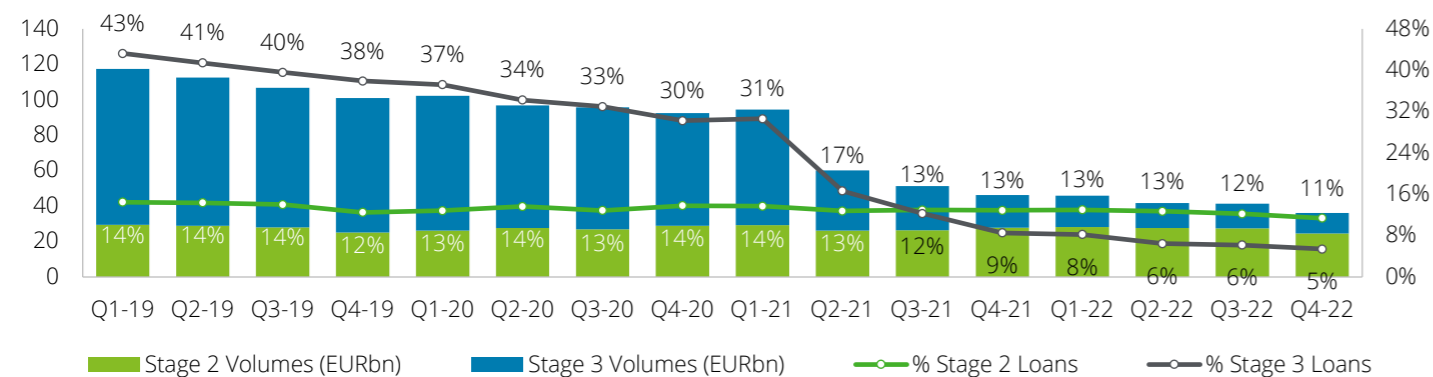
In absolute terms as at 4Q22, the amount of loans classified as Stage 3 held by systemic Greek banks totalled ~€12bn (primarily corporate loan exposures), compared to ~€18bn as at 4Q21. As at their peak as at 3Q15 the volume of NPLs held by Greek banks was more than €115bn³⁶.

Over the period, Greek NPL resolution has also benefited from legislative reform as well as improvements in court processes and in enforcement, including recent favourable judicial decisions allowing licensed credit servicing firms to participate in and conduct auctions directly rather than by proxy on behalf of clients for whom they are acting, thus expediting the process for seizure and subsequent enforcement over acquired real estate collateral.

³⁵ 4Q22 - across the Greek banking sector as a whole

³⁶ IFRS 9 only became effective on 1 January 2018 by which point the volume of credit impaired loans had already reduced significantly

Figure 66: IFRS staging evolution 2019-2022 - Greece



Source: EBA risk dashboard 4Q22

Portfolio market – recent deals

NPL transaction activity tapered in 2022 compared to 2021, with ten completed transactions amounting to ~€6.3bn in total (2021 - €43.7bn). Volumes in 2021 were driven by several highly material HAPS transactions, including Alpha Bank's Project Galaxy €10.8bn. Consequently, by 4Q22, each of the four systemic Banks achieved their targets of reducing NPLs to a single-digit percent for the first time in over a decade.

Ongoing transactions as of 1Q23 amount to ~€6.5bn, of which ~€4.9bn are secondary trades. The secondary market is expected to see a significant increase in activity, with DoValue, one of the country's three largest servicers as a result of Eurobank's Project Cairo carve-out, setting the pace with c.€3.2bn of ongoing projects, having closed Project Virgo (~€450m), part of the Frontier I securitization, in 2022.

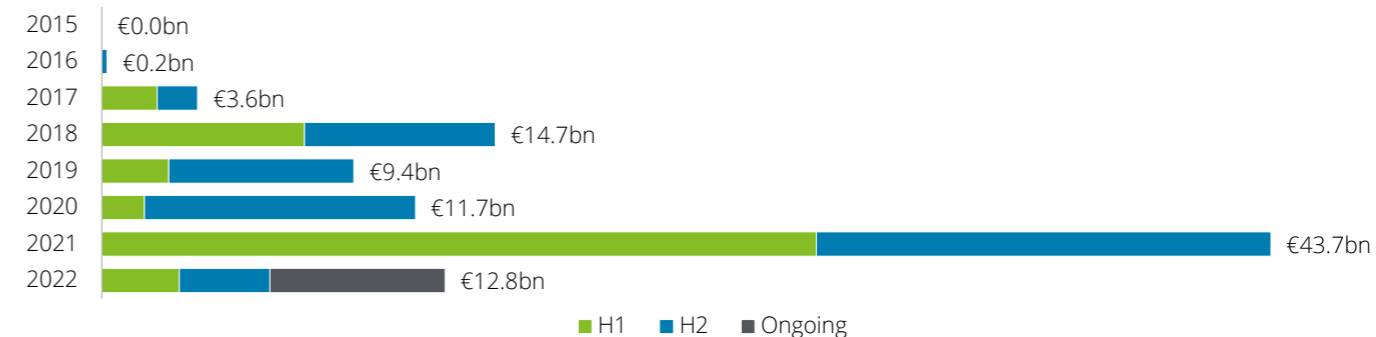
Future outlook

As legacy NPL stocks reduce, Greek banks have moved to synthetic securitizations of performing loan portfolios to further reduce RWA's and drive capital ratio improvement.

Greek banks are also looking to divest REO portfolios onboarded from seized collaterals, and in 1Q23 Alpha Bank closed Project Skyline (~€440m REV), currently considered the largest single sale for the domestic real estate market, while Project Terra (~€450m REV) by Piraeus Bank is reportedly under negotiations.

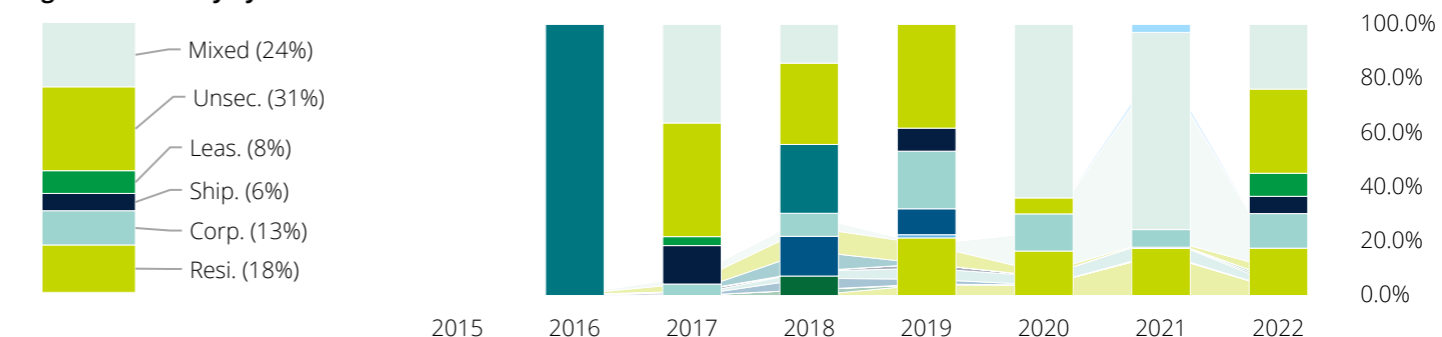
Notwithstanding a reduction in NPL's, the level of loans marked as Stage 2 remains elevated, 11.4% as at 4Q22 compared to 12.5% in 2019 and higher than the EU average of 9.4%. The current higher interest rate/ inflation environment and combined negative effect on household real disposal income, create the risk of a higher NPLs in the medium term, which we anticipate banks will continue to proactively manage including through HAPs securitization transactions.

Figure 67: Activity by year - Greece



Source: Deloitte analysis based on publicly available information - as at 4Q22

Figure 68: Activity by asset class 2022 - Greece



Source: Deloitte analysis based on publicly available information

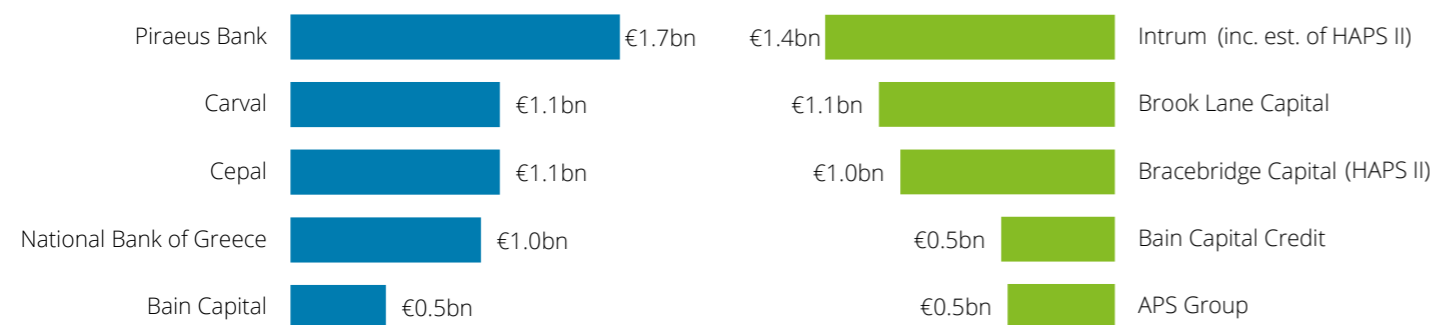
Table 7: Completed transactions in 2022 - Greece

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Project Libra	Unsecured	NPL	CarVal	Intrum	1,100
Confidential	Residential	NPL	Cepal	Brook Lane Capital	1,100
Project Frontier II	Mixed	NPL	National Bank of Greece	Bracebridge Capital (HAPS II)	1,000

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Project Sunshine	Leasing	NPL	Piraeus Bank	Bain Capital Credit	530
Project Sunrise 3	Mixed	NPL	Piraeus Bank	Waterwheel Cap Mgt / Intrum (HAPS II)	500
Project Frame	Corporate	NPL	Bain Capital	APS Group	500
Project Virgo	Unsecured	NPL	DoValue	EOS Group	450
Project Dory	Shipping	NPL	Piraeus Bank	Davidson Kempner	400
Project Light	Unsecured	NPL	Alpha Bank	Hoist Finance	400
Project Trinity	Corporate	NPL	Piraeus Bank	Confidential	300

Source: Deloitte analysis based on publicly available information

Figure 69: Top Sellers and Buyers in 2022 - Greece



Source: Deloitte analysis based on publicly available information (excludes confidential)

France



Macroeconomic overview

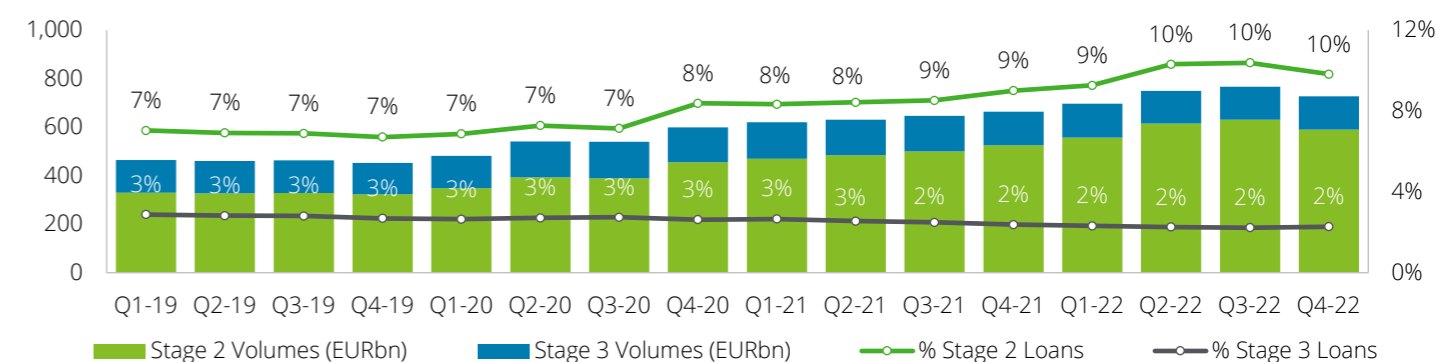
Despite a significant contraction in 2020, as a result of the COVID-19 pandemic and related lockdowns, the French economy rebounded strongly in 2021 with GDP growth of 6.8%, supported by government COVID response stimulus measures. France has not been spared from the effects of the global slowdown on the back of rising inflation, higher interest rates and energy prices (although the latter have now begun to abate) with economic growth of 2.6% in 2022 and a forecast significant slowdown in 2023, to 0.4% of GDP growth.

In the banking sector, after a record year in 2021 and despite a difficult economic environment, almost all the French banks posted results at least equal in 2022. Since the GFC, French banks have increased their resilience and improved the quality of their credit portfolios, while displaying solvency ratios at a level slightly above the average for large European banks.

The level of loans classified as Stage 3 owned by French banks, which includes exposures abroad, totalled ~€137bn as at 4Q22, virtually unchanged since 4Q21 (~€139bn), representing the largest level of stock in Europe³⁷. The overall percentage of loans classified as Stage 3 remained low at 2.3%. The level of domestic NPL, however, increased by 4% between December 2021 and December 2022, returning to the 2020 level of €70bn. Corporate bankruptcies and household over indebtedness remained low reflecting French government measures to support businesses and individuals, including the Prêt Garanti par l'État ("PGE") government guaranteed loans, economic stimulus package and loan moratoria.

Notwithstanding, French banks are sitting on sizeable stocks of Stage 2 loans, which increased significantly during the pandemic from €324bn as at 4Q19 to €631bn as at 3Q22 – 4Q22 was €590bn.

Figure 70: IFRS staging evolution 2019-2022 - France



Source: EBA risk dashboard 4Q22

³⁷ Considering NPLs as an alternative measure these were ~€111bn as at 4Q22

Portfolio market – recent deals

The loan portfolio market in France is less developed than in neighbouring European countries, as banks typically have worked out NPLs internally; spurred in part by regulatory pressure this has started to change in recent years, with larger, more visible secured NPL trades. While activity slowed at the onset of the pandemic, several large deals completed in 4Q20 and 1Q21, including a disposal from first time seller Crédit Logement and two sizeable corporate NPL sales. Local debt purchasing and servicing players acquired over 90% of all trades. Unsecured portfolios, often under the radar for foreign investors, represented 60% of all deals in 2021, and while that trend was briefly inversed during H1 2022, overall, 70% of portfolios traded in 2022 were unsecured.

Contemplated disposals of servicing platforms multiplied in 2022, but outside the sale of Recocash to PE fund Qualium, deals were unsuccessful or went quiet.

In a further new trend, the secondary market looks to be gaining momentum, with multiple transactions launched by debt servicers to sell or refinance their unsecured and secured books. With European regulators increasingly looking at secondary markets as an efficient method for NPL resolution, this may further democratize the practice in France.

Future outlook

The end of government support measures, coupled with uncertain economic conditions, is expected to see a steady rise in secured and unsecured UTP and defaulted loans, as well as increased pressure on banks to sell to minimise RWA levels, albeit at present credit quality appears to be relatively robust, and the French market has historically demonstrated its resistance to following expected trends. Nonetheless, the level of Stage 2 loans has been increasing in recent years from 8.4% as at 4Q20 to 9.8% as at 4Q22 (10.4% as at 3Q22).

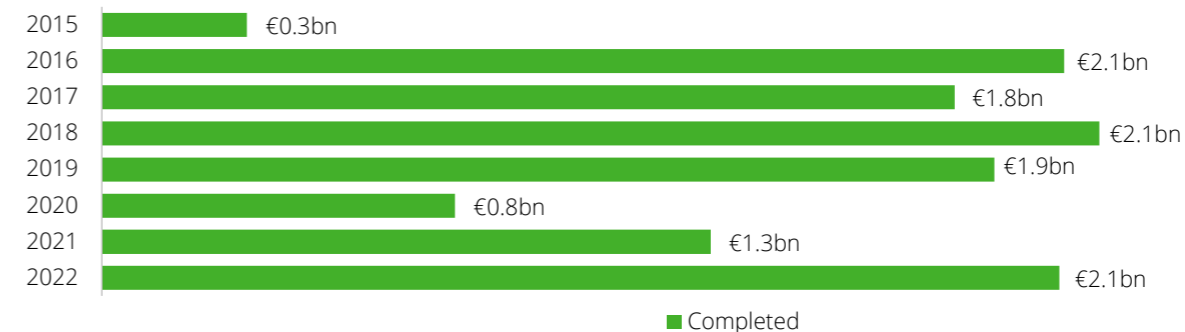
The number of corporate bankruptcies increased by ~50% over 2021 levels to 41k in 2022 and, while still at a lower level than 2019, the pace is accelerating pointing to a return to pre-crisis levels faster than expected.

On the retail side, pressure on household spending and anticipated higher levels of individual overindebtedness could lead to new defaults on secured and unsecured loans, while new rules around the prudential backstop make it expensive for banks to hold defaulted consumer loans.

While it may still be premature to declare a significant shift in the French market, there is a high probability that activity will persist at least at the levels seen pre-pandemic. In the short term, this will be driven more by regulatory pressure and cost cutting than by new asset quality issues.

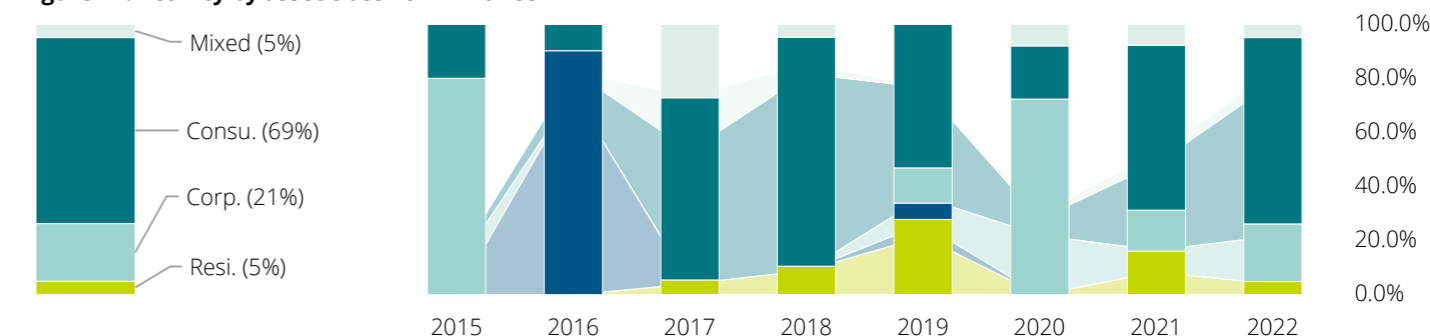
We anticipate, one-off disposals of large, secured portfolios and high steady volumes of unsecured consumer portfolios will likely pick up pace in 2H23 and 2024. New forward flow partnerships and disposals of fresher portfolios can also be expected, but a growth in secondary sales also remains a further potential opportunity for investors.

Figure 71: Activity by year - France (completed transactions)



Source: Deloitte analysis based on publicly available information

Figure 72: Activity by asset class 2022 - France



Source: Deloitte analysis based on publicly available information

Table 8: Completed transactions in 2022 - France

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Confidential	Consumer	NPL	Confidential	Confidential	350
Confidential	Consumer	NPL	Confidential	Confidential	300
Sakura	Corporate	NPL	Societe Generale	EOS	240

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Confidential	Consumer	NPL	Confidential	Confidential	200
Confidential	Consumer	NPL	Confidential	Confidential	120
Confidential	Consumer	NPL	Confidential	Confidential	100
Confidential	Residential	NPL	Confidential	Confidential	100
Confidential	Mixed	NPL	Confidential	Confidential	100
Confidential	Consumer	NPL	Confidential	Confidential	100
Confidential	Corporate	NPL	Confidential	Confidential	80

Source: Deloitte analysis based on publicly available information

Germany

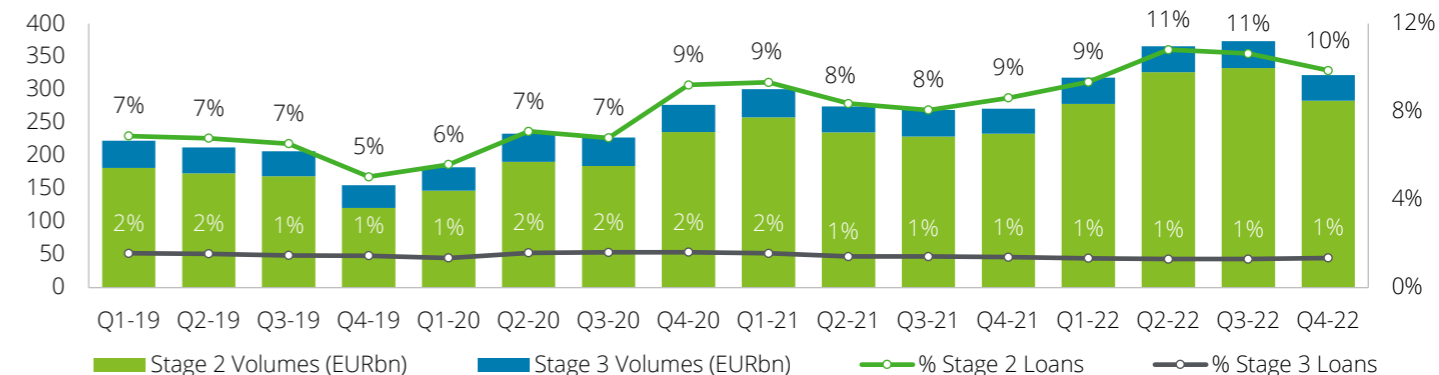


Macroeconomic overview

The German economy slowed in 2022 – with real GDP growth of 1.9% compared to 2.6% in 2021 (albeit 2021 came after a 4.1% fall of in 2020) – reflecting elevated inflation, monetary tightening, and a fall in real terms disposable incomes as seen across other European countries. GDP is forecast to fall slightly in 2023 (-0.1%) and record only sluggish growth rates in 2024 and 2025 (average 1.3%)³⁸.

Despite this challenging environment, for the present at least, asset quality metrics for the main German banks remain sound. German banks started into the pandemic with a sound liquidity buffer and were well capitalised. NPL volumes in Germany have remained broadly static over the last few years, with the percentage of loans classified as Stage 3 falling from 1.4% as at 4Q19 to 1.3% in 4Q22, reflecting successful business support measures which have slowed new NPL generation, including loan moratoria and various government backed lending schemes throughout the pandemic as well utility subsidies since the start of the Ukraine conflict.

Figure 73: IFRS staging evolution 2019-2022 - Germany



Source: EBA risk dashboard 4Q22

Portfolio market - recent deals

As observed in other jurisdictions, transaction activity slowed following the initial outbreak of the pandemic. Previously initiated deals were mainly closed in 2020 but new launches were put on hold. The 2020 closed transactions included a performing corporate portfolio which was traded between banks while the NPL portfolios (CRE portfolio as well as portfolios consisting of residual claims) were sold to PE funds. During 2021 only €0.4bn was traded.

³⁸ EIU as at March 2023

Transaction activity picked up significantly in 2022 (~€2.1bn transacted) with hsh portfoliomanagement AöR's sale of its performing shipping book to a consortium of Bank of America and Davidson Kempner in H1, followed by the sale in H2 of its book of residual claims against mostly single vessel entities in insolvency proceedings to a confidential buyer. Further portfolio sales of residual claims were conducted in 2022.

Shipping debt as well as corporate portfolios remain the principal asset classes traded in the recent years, making up 69% of total assets traded between 2015 and 2022.

There are several opportunities under consideration by potential sellers which may come to market in 2023 but have not yet been announced publicly.

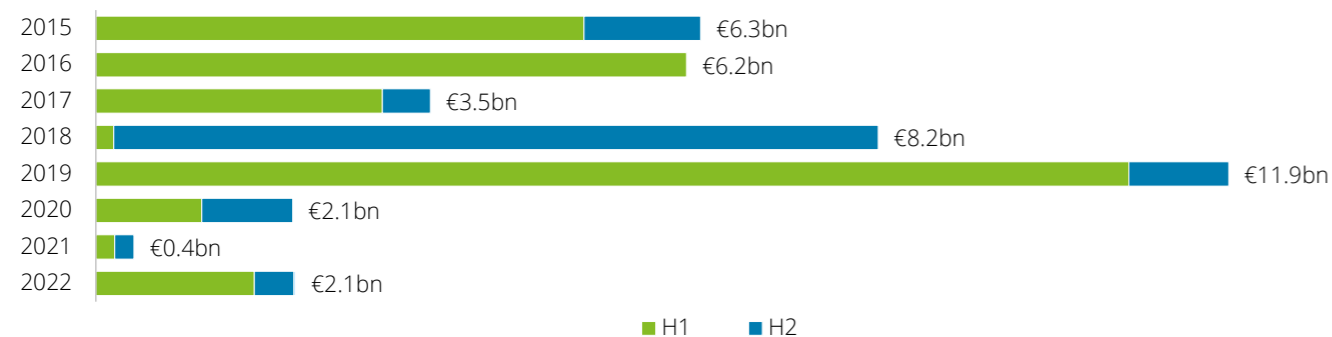
Future outlook

Notwithstanding low levels of NPLs, loans marked as Stage 2 increased from 8.4% as at 2Q21 to 9.9% as 4Q22.

Notwithstanding some easing in inflation, with CPI reducing from 8.7% January and February 2023 to 7.4% in March 2023,³⁹ ongoing high interest rates and challenging macro-economic conditions, banks remain vulnerable to an increase in NPLs. In particular, banks may seek to proactively manage exposures at greater risk of default including across the consumer, SME and residential mortgage sectors (both secured and unsecured), through ongoing divestment activity.

At the same time, new regulatory requirements (including the NPL prudential backstop) and ESG objectives, may see the divestment of loans not fulfilling these requirements, especially NPEs outside banks' strategic focus, as well as single name transactions.

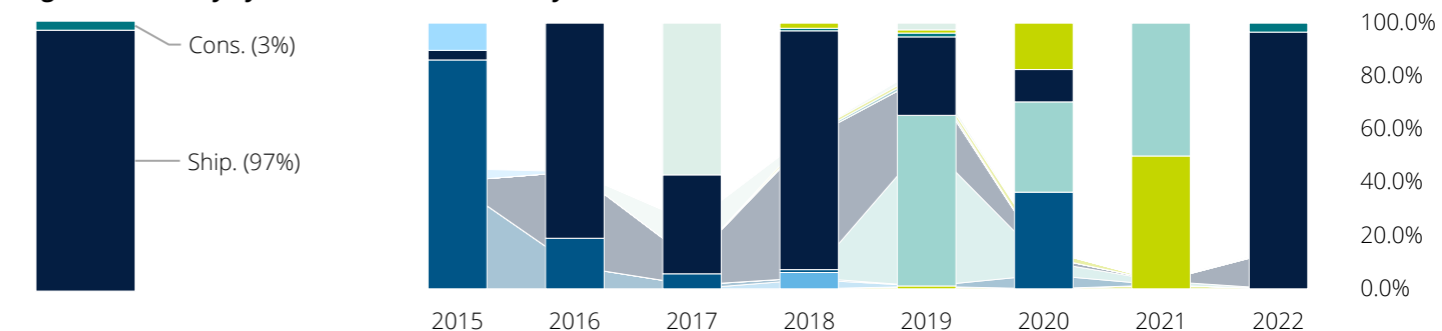
Figure 74: Activity by year - Germany



Source: Deloitte analysis based on publicly available information

³⁹ Consumer price index - overall index and by 12 divisions - German Federal Statistical Office (destatis.de)

Figure 75: Activity by asset class 2022 - Germany



Source: Deloitte analysis based on publicly available information

Table 9: Completed transactions in 2022 - Germany

Portfolio	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Project Blue Water	Shipping	PL	hsh portfolio-management AöR	Bank of America; Davidson Kempner	1,590
Confidential	Consumer	PL	Confidential	Confidential	70
Project Blue Ocean	Shipping	NPL	hsh portfolio-management AöR	Confidential	415
Project Blue Pearl	Shipping	NPL	NordLB	Hoist	n/a

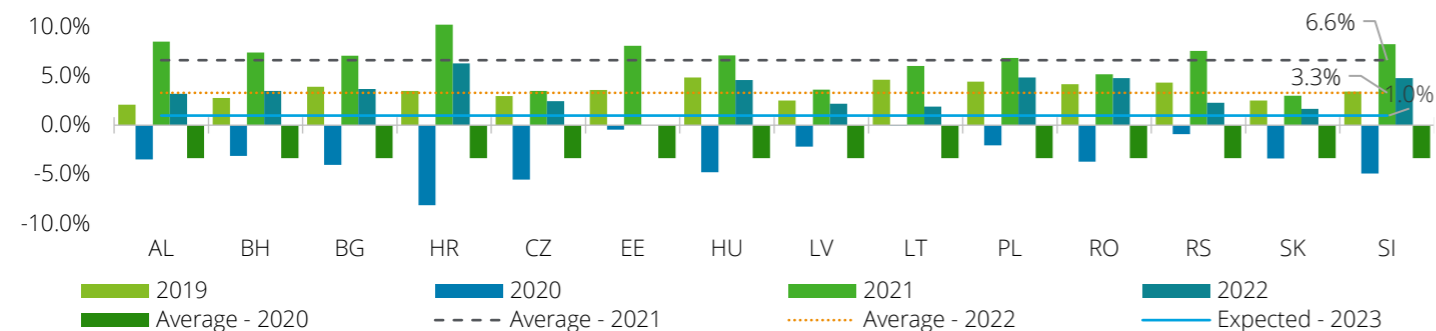
Central & Eastern Europe



Macroeconomic overview

The CEE region showed significant economic growth in 2021 (6.6% on average⁴⁰) as COVID restrictions were eased and with rebounding demand, especially in the services sector, but, as with the rest of Europe, slowed during 2022 (to an average of 3.3%), as central banks started aggressively tightening monetary policies to rein in inflationary pressures, and given the conflict in Ukraine.

Figure 76: CEE GDP growth 2019-2022



Source: EIU

Subdued growth of around 1% is expected in 2023⁴¹, reflecting ongoing elevated levels of inflation and real terms falls in household income, along with ongoing geopolitical tensions.

Banking sector overview

The CEE banking sector was significantly affected following Russia's invasion of Ukraine in February 2022, and by the resultant different sanctions packages announced by the ECB and other regulators, including as a result of the ECB's decision on 28 February 2022 to declare Russian-owned, Sberbank Europe AG (headquartered in Vienna, Austria) and its two Banking Union, subsidiaries, Sberbank d.d. (Croatia) and Sberbank banka d.d. (Slovenia), failing-or-likely-to-fail ("FOLTF"), as a result of a rapid deterioration in their liquidity and capital position. Regulators in Czechia, Bosnia and Herzegovina, Hungary and Serbia, also took action, with the banking licences of Sberbank subsidiaries in the Czech Republic and Hungary being revoked and each entering into liquidation processes.

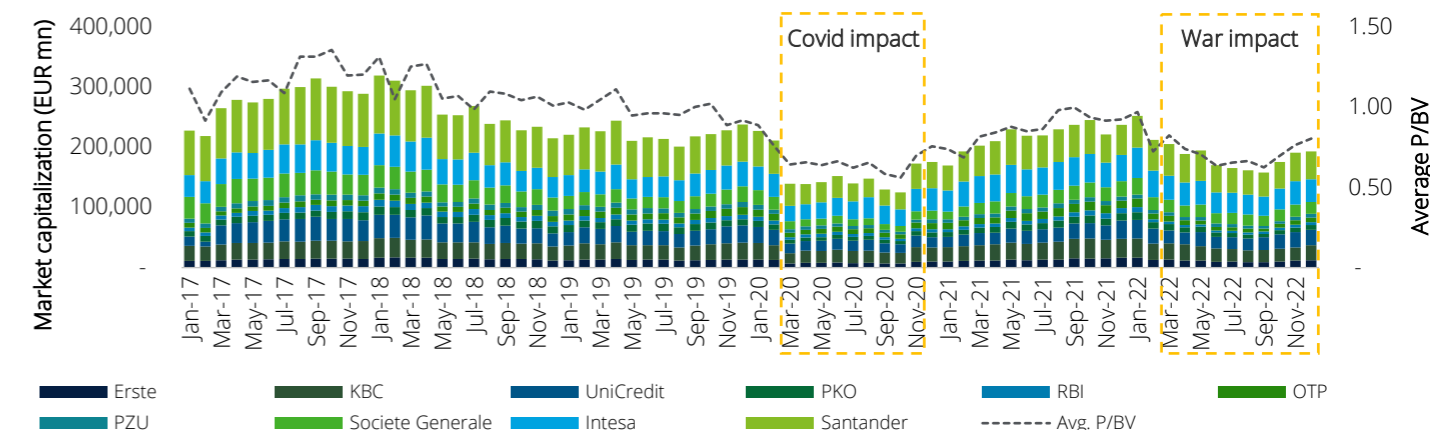
Notwithstanding the positive impact of higher interest rates on banks' NII, higher energy prices, inflation and general market uncertainty,

40 Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Serbia, Slovakia & Slovenia

41 EIU

depressed bank valuations, with the market capitalisation of the largest banking groups in the CEE region⁴² falling by 33% between the end of 2021 and the end of September 2022, even though levels have since started to improve.

Figure 77: CEE bank market capitalisation 2017-2022



Source: Capital IQ

In addition, Polish banks have continued to be impacted by ongoing litigation related to CHF mortgages.

Asset quality⁴³

Despite the current turbulent market environment, the NPL ratio continued its downward trajectory reaching 2.9% on average across CEE at the end of 2022 – a 1.4%p decrease since 2020. Overall NPL stocks have also gradually decreased to €31.6bn at the end of 4Q22 (€38.7bn in 2019), with the ongoing conflict in Ukraine not yet having a material negative impact on the default rate in the CEE region, given the relatively small overall exposure of banks within these countries to Ukraine.

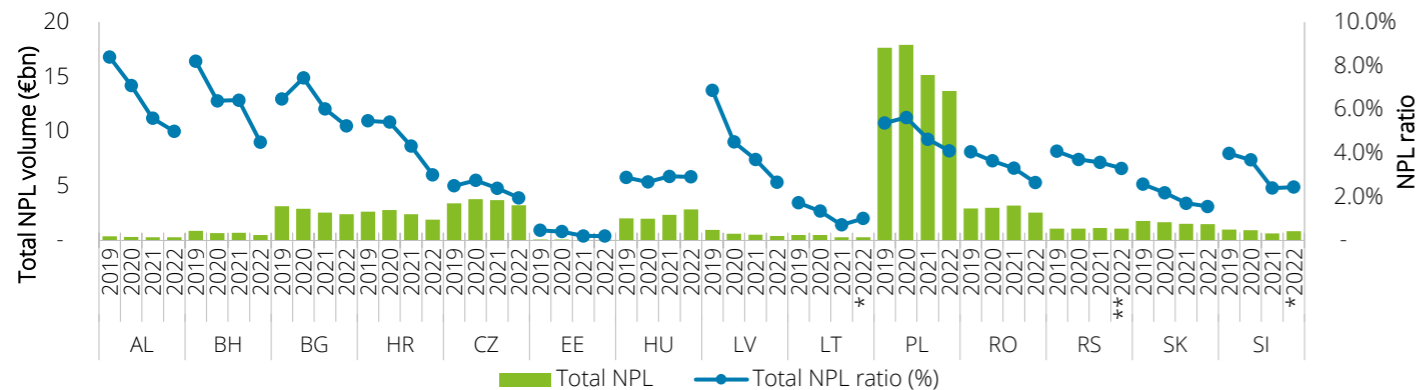
The rate of NPL reduction was, however, somewhat uneven across the region, with Hungary (+€479m), Slovenia (+€200m) and Albania (+€9m) recording an increase in NPL stocks.

The highest total NPL ratios were reported in Bulgaria (5.2%), Albania (5.0%) and Bosnia and Herzegovina (4.5%) in 2022, but on an improving trajectory. The lowest NPL ratios were Estonia (0.2%), Lithuania (1.0%) and Slovakia (1.6%) in 2022.

42 Being: Erste Bank, KBC, UniCredit, PKO, RBI, OTP, PZU, Société Générale, Intesa & Santander

43 NPL ratios and volumes based on National Bank's data and includes, banks not monitored by the EBA and those located in non-EU countries

Figure 78: CEE NPL evolution 2019-2022 (by country)



Source: Deloitte analysis, National banks' data. Please note that NPL category distribution for Serbia in 2Q22 was not available. * Please note that only Q3 data was available ** Please note that only Q2 data was available

The NPL ratio in the corporate segment fell from 5.1% at the end of 2021 to 4.0% at the end of 2022 and the NPL ratio in the retail segment abated from 3.4% at the end of 2021 to 2.9% at the end of 2022⁴⁴.

Figure 79: CEE NPL evolution 2019-2022 (by country/ by sector)



Source: Deloitte analysis, National banks' data. Please note that NPL category distribution for Serbia in 2Q22 was not available. * Please note that only Q3 data was available ** Please note that only Q2 data was available

44 Please note that the breakdown for Albania and Serbia was not available.

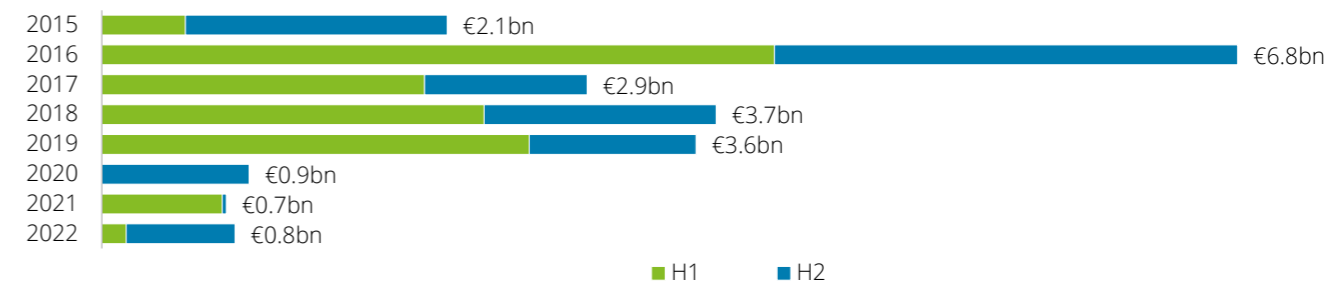
Portfolio market – recent deals

The Sberbank situation has resulted in some limited portfolio transaction activity including:

- Hungary: As part of the liquidation process, Sberbank Magyarország Zrt's loan book was sold in a competitive process to MBH-owned MKB Bank.
- Czech Republic: Erste-owned Ceska Sporitelna agreed to acquire a major part of the loan portfolio for ~€135m in July 2022, the transaction is expected to close in 2023.

The CEE loan portfolio market has otherwise remained subdued over the last few years, with various government stimulus packages introduced during the pandemic also proving effective in limiting the rate of new NPL formation.

Figure 80: Activity by year - Central & Eastern Europe



Source: Deloitte analysis based on publicly available information – includes Austria

Table 10: Completed transactions in 2022 - Central & Eastern Europe

Portfolio	Country	Asset Class	PL/NPL	Seller	Buyer	Size (€m)
Confidential	Romania	Other	NPL	Bank of Cyprus	APS	147
Project Dove	Hungary	Mixed	PL/NPL	Sberbank Magyarország Zrt	MKB Bank Nyrt.	650

Source: Deloitte analysis based on publicly available information – includes Austria

Future outlook

Recently banks in larger CEE countries have commenced processes to bring sizeable legacy NPL portfolios to market which are either ongoing or have not yet come to market. Given the ongoing challenging macroeconomic conditions we anticipate a more active 2H23 and beyond, particularly in those countries with more developed banking systems and higher NPL stocks.

Deloitte's Corporate Finance Advisory Financial Institution Group

Deloitte Portfolio Lead Advisory

Deloitte's Portfolio Lead Advisory Services team ("PLAS") is a global market leading practice, with a dedicated team based in London, specialising in providing clients with end-to-end advice and assistance spanning loan portfolios, single-name exposures, capital optimisation and securitisation. It has an outstanding market reputation covering deleveraging and strategic advisory, transaction advisory and support and balance sheet advisory.

The senior team has advised governments, financial institutions, regulatory authorities and global investors on transactions across every major asset class covering over €600bn of assets. PLAS is supported by a dedicated network of 140 professionals across the world.



Credit Solutions

Full-service market advisory to financial institutions and other holders of loans from asset sales to providing funding solutions. We advise throughout the lifecycle of a transaction from strategy and preparation to sales execution



Sell-side Advisory

Full-service market advisory to financial institutions and other holders of loans from asset sales to providing funding solutions. We advise throughout the lifecycle of a transaction from strategy and preparation to sales execution



Buy-side Advisory

Supporting investors with all aspects of due diligence on loan portfolios including analysis, underwriting, structuring and pricing

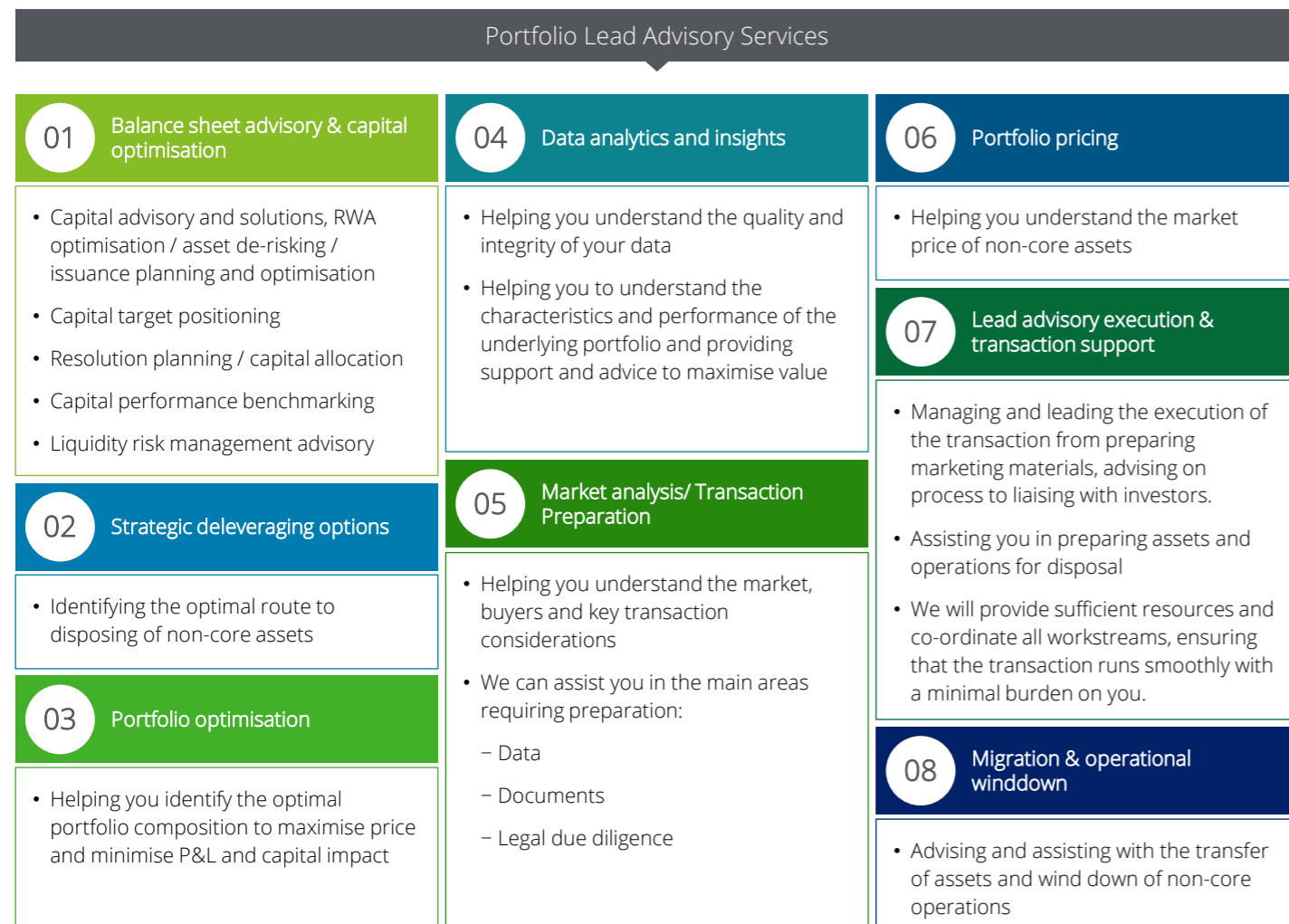


Balance sheet Advisory

Advising financial institutions on their capital/liability strategies and options, credit risk management and de-risking tools. Comprehensive support in stakeholder outreach

How we can help

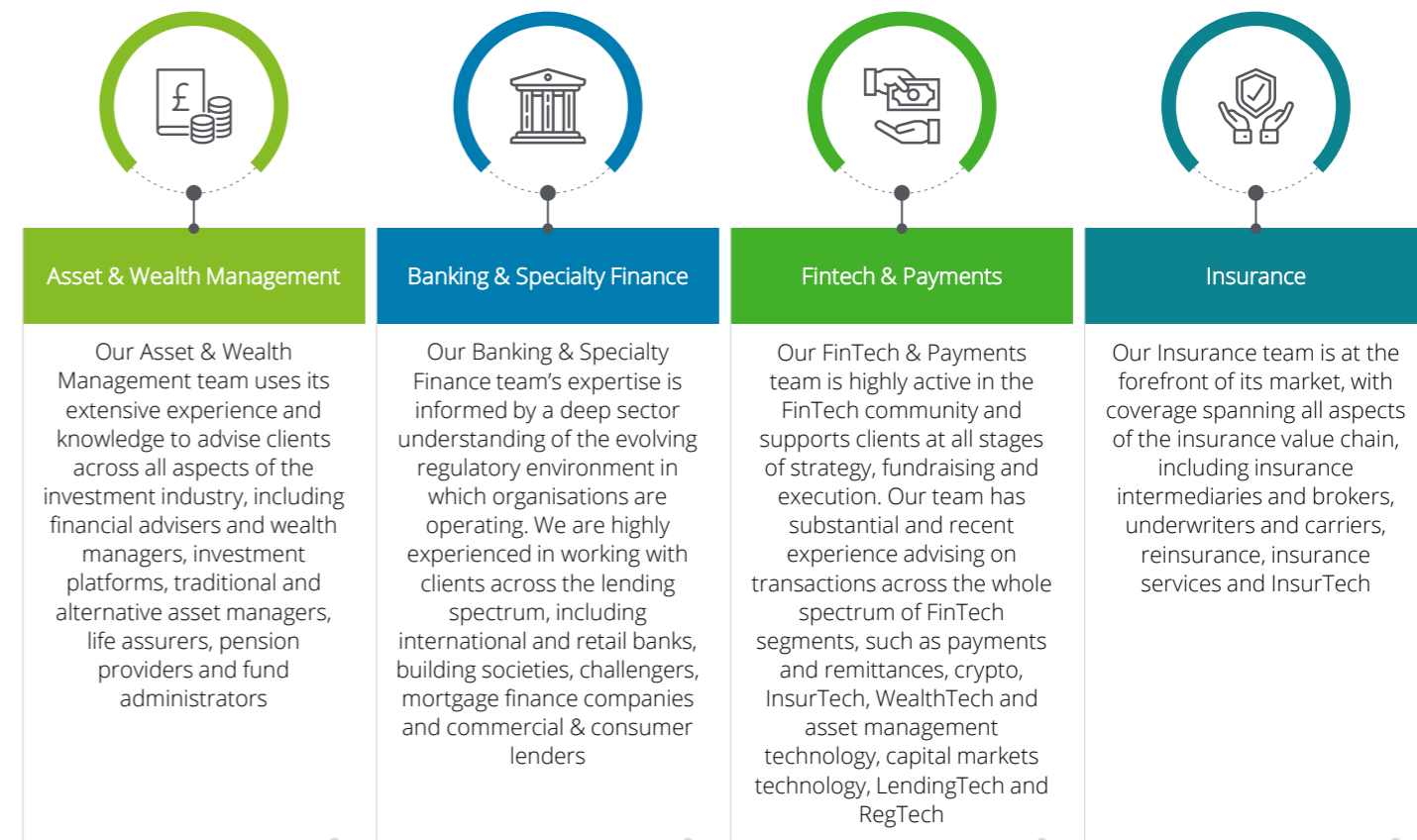
We specialise in providing end-to-end support and advice throughout the life cycle of a transaction



Strategic Advisory and M&A

Deloitte's FIG Corporate Finance Advisory team is a diverse group of dedicated corporate finance practitioners with years of sector-specific corporate finance experience working for bulge bracket investment banks, boutiques and Big Four accounting and advisory firms. Our FIG specialists cover both domestic and international transactions, with a particular focus on the UK and wider EMEA market. The Partner led group is highly experienced, has deep client relationships and acts as trusted advisor to large and mid-cap financial services clients. The team has a very impressive track record working across capital markets, M&A and restructuring, with deal sizes up to USD multiple billions.

In addition, our team is supported by a dedicated global network of consulting, due diligence, tax and regulatory sector experts, allowing us to offer our clients the full complement of end-to-end M&A services all under one roof.



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Deloitte's R&R team provides strategic advice, planning and design solutions to support FS clients in, and prepare for, distress. The team is a trusted advisor to both resolution authorities, having advised on Banco Popular, SVB UK and dozens of other contingency planning situations, and to Boards and Senior Management of FS firms to navigate recovery and resolution planning, and to implement these plans in distressed situations.

The team includes individuals with experience advising clients globally, coupled with unrivalled understanding and insight into regulatory expectations, including individuals who have helped to design the regulators' policy in this space.

Our key focus areas



Strategic recovery and resolution advisory

Advising FS firms and resolution authorities to implement recovery and resolution capabilities through the provision of strategic advice, planning and design solutions to ensure preparation for times of distress

Restructuring planning

Conduct end-to-end restructuring planning programmes, including the strategic planning and execution of recovery and restructuring options for firms in BAU and in distress

Supporting FS firms through distress

Support FS firms through distress, including the planning and execution of restructuring options to return firms to viability e.g. wind down, separability, IPO and M&A transactions

Strategic regulatory advice

The team has the capabilities to provide broad regulatory advice and input into a wide range of transactions and other FIG activities



Appendices

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