The Covid Impact on Private & Alternative Credit in Europe

Navigating the Unknown

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Executive Summary

In this report, we look at the impact of the covid crisis on private and alternative credit markets in Europe, spanning mortgage, consumer and small-/ mid-cap corporate credit. On our estimates, this non-bank specialty lender-led market has a footprint of roughly €350bn in terms of loan stock, dominated by the UK.

The covid pandemic is of course an unparalleled crisis in its scale and intensity. And the policy-maker response has been equally without precedent, generally comprising a three-prong approach made up of exceptional monetary accommodation, emergency fiscal stimulus measures and loan forbearance initiatives. The response to the covid pandemic hitherto has already far surpassed policy actions taken during the 2008/9 crisis.

In the near-term at least, we feel the fiscal measures in place will provide appreciable support for debt servicing burdens while also cushioning any repayment shocks as some borrowers emerge from payment moratoriums. Household credit stands to benefit most in this respect, in our view. Rather than loan book credit deterioration, we see lender financing and/or liquidity distress as the main near-term casualty from the covid crisis, given the extent of forbearance on the one hand and the more selective liquidity within securitization and institutional funding markets on the other. (Non-banks and speciality credit assets generally fall outside central bank liquidity and asset purchase envelopes, with very few exceptions). This squeeze on many non-bank lender models may provide interesting private market 'back-book' opportunities in the coming months.

The longer-term crisis impact on private credit performance depends largely of course on its ultimate toll on employment and business survival. At this stage we see unsecured credit as being at most risk, save potentially for some higher margin loan books which may be insulated by adequately rich yields. Mid-cap corporate portfolios may also be vulnerable if default expectations in the larger-cap leveraged finance market is any guide. (Indeed, this crisis will be the first real test for private debt funds, and also for the likes of marketplace lenders). Residential mortgages should prove the most credit defensive, in our opinion.

Covid brings the 2010s alternative credit cycle to an abrupt end. In its aftermath, we see a fresh cycle of front-book opportunities re-emerging apace to coincide with renewed demand for specialty credit. Compelling risk-return economics (typical in any early-cycle lending) against the backdrop of prolonged ultra-low rates should underpin the merits of private loan book investing, once again.

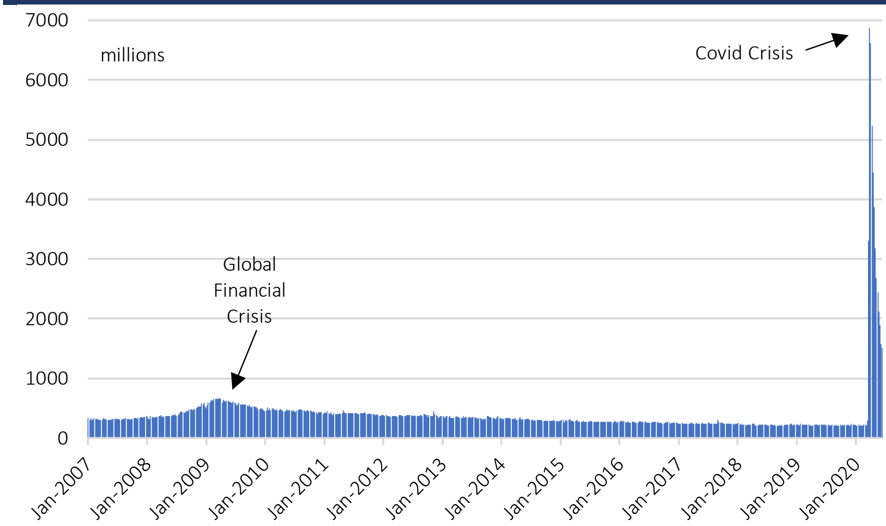
Covid Policy Actions – An Unprecedented Response

No peacetime parallel, no sectors spared

The covid pandemic is of course an unprecedented crisis in its scale and intensity, with few peacetime parallels. Unlike previous crises, the impact of the abrupt lockdowns has been unique given the coincident demand and supply shocks that manifested immediately with the near-complete shutdown of economic activity. What is also unique about the covid crisis is the immediate, 'waterfront' impact across substantially all segments of the real economy. There are no epicentres like in past crises.

The path back to economic normality depends, in the first instance, on whether deconfinement plans can be sustained, and beyond that on the extent of any lasting economic scarring from the pandemic crisis.

US unemployment claims evidences the scale of the covid crisis



Source: US Dept of Labor

Three-prong policy response

The global financial and economic policy response to the pandemic crisis has been equally unprecedented, by almost any measure. Country responses have followed a broadly consistent format, comprising a three-prong approach: central bank-led support for market functioning and liquidity, government-led fiscal stimulus and lender- or policy-led credit forbearance. While the monetary response from central banks was largely centred on the 2008 crisis 'playbook', the fiscal and credit actions have few modern-day parallels. Taken in its entirely, the scale of covid-related policy actions has far surpassed the response seen in the 2008 crisis aftermath, and indeed anything witnessed in post-war financial history.

Central Bank Actions

Central bank support for financial market functioning and liquidity has come in the form of resumptions in asset purchases (via programmes that were generally being tapered some 10 years following the last crisis) as well as fresh liquidity/ funding initiatives targeted at selected borrower or loan markets, aside from deep rate cuts in most cases.

Unprecedented asset purchases, but not overly focussed on credit …

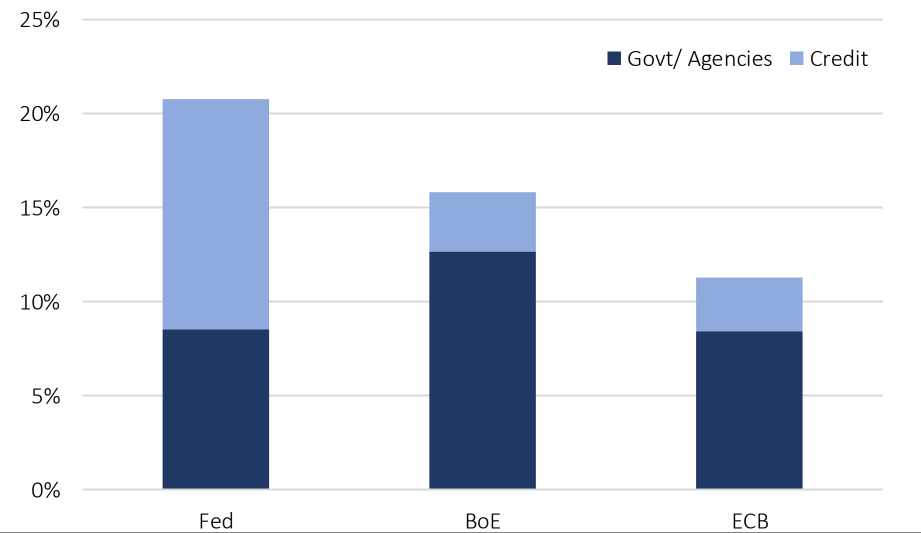
The EU/ UK bond-buying programmes – while without precedent in its scale – have lesser emphasis on credit relative to the Fed. The Fed's coverage has spanned corporate bonds across much of the rating spectrum (including a primary market buying programme), municipals and asset-backed securities via the resurrection of TALF, a co-investment ABS buying scheme first conceived in 2009. For the first time, the asset risk envelope in the US includes high yield credit – including via ETF purchases – as well as senior static CLOs and CMBS.

The ECB also for the first time made provisions for the inclusion of selected high yield credit in its expanded QE programme, limited however to recently downgraded investment grade bonds (fallen angels). The ECB's QE programme continues to notably include senior ABS but subject to quality and transparency criteria, as before. BoE's QE programme remains targeted at government bonds mostly, however the UK central bank initiated a CP facility (undisclosed size) at the outset of the pandemic targeted directly at investment grade corporates.

… complemented by dedicated funding facilities

Closely complementing asset purchases are the central bank funding facilities that were also launched or restarted upon the onset of the pandemic crisis. Such facilities typically provide financing / liquidity against whole loan credit assets, rather than via outright purchases. The BoE resurrected its TFS scheme targeted at bank SME lending, doubling the base stock allowance from the earlier version. The ECB has relied on its unlimited, full-allotment and fixed (now reduced) rate TLTRO facility rather than any fresh direct lending programme targeted outside the banking system, complementing it with a specific parallel facility set-up on generous terms during the pandemic emergency (PELTRO). Yet again, the US looks to be a stand-out in terms of the scale, with the key plank of the Fed's funding support – the Main Street Lending Facility – breaking new ground by directly supporting local governments and the SME corporate economy.

Comparing asset purchase plans shows the Fed as the better buyer of credit (% of GDP)



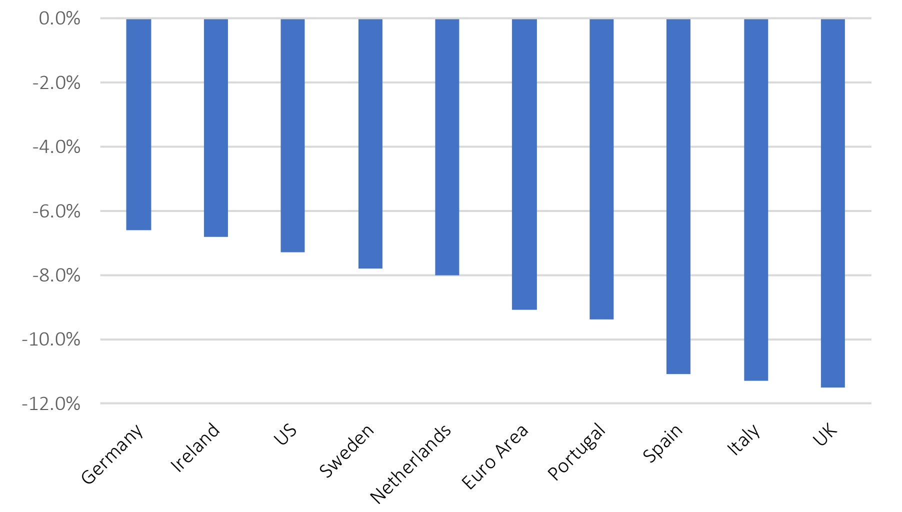
Source: Integer Advisors calculations based on Fed, BoE and ECB statements. Data captures post-covid programme increments based on their caps, except for Fed (unlimited programme) which is based on actual. Estimates used to size credit-targeted policy in the case of BoE and ECB, based on past deployments

Specialty credit lenders and assets have been mostly left out

Isolating private or specialty credit, we would note that there has been no *direct* financing or liquidity support provided to non-bank lenders or specialty loan books, save to some extent for the criteria-heavy ECB's ABSPP. (The ABSPP – which explicitly excludes any CLOs – is notably subject to some market participation as one of the many pre-requisites, making its use very limited for non-banks during market dislocations). By contrast, support mechanisms in the US have greater transmission or filter-down benefits for the specialty credit markets. Even in Australia, policy makers have initiated a A$15bn RMBS-purchasing programme targeted specifically at non-bank lenders.

Still, the unprecedented central bank overall response to the crisis looked to have served its purpose, at least for now, in stabilising market functioning in the immediate aftermath of the violent sell-off in March, and indeed arguably fuelling the recovery in risk asset markets since then. Listed credit markets have certainly been a beneficiary to this recent reflation, but it's still too early to tell if there have been any positive feedback loops into unlisted credit in terms of better private investor sentiment and/or liquidity. We would expect further central bank actions going forward to counter the real economic fallout from the covid crisis.

2020 forecasts for nominal GDP point to unprecedented economic contractions



Source: OECD. Assumes 'single-hit' from the pandemic

Fiscal Stimulus

Massive fiscal packages …

The fiscal response to the covid pandemic has centred mainly on direct wage and social security support (including unemployment benefits) for households, and direct funding support for businesses. Tax deferrals have been central to the fiscal impulse in many jurisdictions. Selected countries, to notably include the US, have resorted to 'helicopter money' (i.e., direct monetary transfers to households), as well as forgivable loans to selected businesses, as part of the fiscal effort to cushion the impact of covid. Fiscal stimulus in most jurisdictions has been complemented by some degree of relaxation of regulatory capital and leverage ratio compliance for banks, in order to incentivize fresh lending. In Europe, banks have been allowed to utilize their capital buffers with immediate effect.

… comprising extraordinary wage support for households …

In the case of households, wage support has been concentrated in countries without significant social safety nets (or restrictive labour laws), with the policy of preserving substantially most of the income of employees that have been furloughed or laid-off on account of the pandemic being the common principle throughout. This support normally extends to the self-employed affected by the covid lockdown. Caps and other thresholds typically apply in most country wage or unemployment benefit programmes, with all such schemes temporary in nature, in most cases 3 to 6 months in duration.

… and financial support for businesses

In the case of businesses, the thrust of fiscal initiatives has been around providing loans and grants/ subsidies to corporate sectors. Tax holiday breaks have also been used widely as a means of payment relief for businesses. In some countries like the US and UK, businesses have relied upon the extraordinary wage support or unemployment benefit cushions available for furloughed employees as a means of managing the pandemic shutdown.

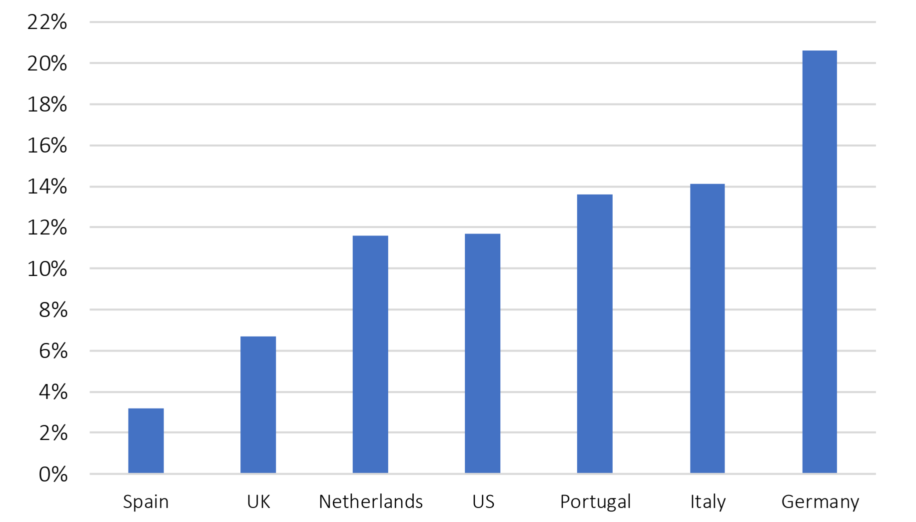
SMEs are the main beneficiaries among corporates …

Loans targeted at the corporate economy have generally been segmented into SME financing programmes and facilities aimed at larger-cap corporates. As a general observation, we would surmise that financing targeted at SMEs and micro businesses has typically dominated the fiscal policy response, naturally as larger-cap businesses with capital market access can be expected to benefit also from central bank monetary accommodation. (Exceptions with regard to the latter have been bailouts of certain large corporates in strategic industries such as aviation). Loans are originated directly by state-owned lending intermediaries or lent via the incumbent lender system made up of banks and, in a few cases such as the US and UK, non-banks also. (Non-banks span fincos to fintech-based marketplace lenders). There is normally minimal underwriting, with the lenders acting more as conduits or gatekeepers rather than credit owners, reflecting the fact that most such loans come with government guarantees.

… but the criteria-laden schemes have their limitations

Such financing schemes targeting small-caps have been designed with many rules and criteria that generally restrict the recipient types (depending on ownership status) while governing job retention obligations and dividend payouts, among many other requirements. SME financing schemes also come with rules in terms of the use of proceeds (no diversion to equity being an ubiquitous requirement, for example), with restrictions in some cases for using monies to pay down existing debt. The hasty implementation of such programmes has meant that there have been some grey areas in terms of usage and unintended outcomes in terms of access. The likes of non-bank specialty lenders and real estate owners have been mostly excluded from such schemes, sometimes because of close-links to financial parents such as private equity firms.

Emergency fiscal firepower has varied by country (% of GDP)



Source: Bruegel. Excludes EC/ EU-wide packages

In comparing the overall fiscal impulse across geographies, we would note that certain European countries – notably including Germany and Italy – have provided the greatest extent of overall fiscal support compared to other major economies.

The fiscal rush will be crucial in supporting credit behaviour

Fiscal policy has played a crucial role in absorbing the early impact of covid on household and business finances, and therefore their respective debt servicing capabilities. But such extraordinary government support has been conditioned as temporary measures in all cases, meaning that its effects have been to merely delay the onset of the longer-term economic impact of the covid pandemic. We expect to see a second round of fiscal stimulus as countries move from emergency aid to measures aimed at mitigating the longer-term fallout on the real economy. Germany was among the first to do so with a €130bn fiscal package announced in early June.

Economy-Wide Loan Forbearance

The extent of loan moratoriums has no precedent either

The covid crisis triggered economy-wide forbearance measures in most countries, a policy response with little historical precedent. Even in past periods of payment distress – such as in the aftermath of the deep housing recession in the early 1990s or the 2008 global financial crisis – debt servicing moratoriums were seldom systematically implemented. The closest comparable may be the US federal mortgage loan modification programmes (HAMP and HARP) or the Italian moratorium on SME debt post-2008, but these were much less radical in their scope, limited largely to defaulting borrowers.

Payment holiday formats vary

Pre-emptive forbearance measures put in place in recent months are mostly non-mandatory, regulator-led requirements on lenders or servicers to offer payment holidays to households and businesses facing repayment difficulties, subject to certain criteria. Most such criteria apply in the case of non-vanilla loans and/or to certain borrower types. Standard consumer instalment loans are typically covered, extending to residential mortgages and established lending types such as auto loans and credit cards in the case of households. Unsecured small business loans and other non-complex financing facilities to SMEs are also normally eligible for borrower payment freezes. Lenders may have discretion in underwriting such requests from eligible borrowers, however in a few cases legislation gives borrowers the right to payment moratoriums. (See table below). Capital and loss accounting (IFRS9) rules have been relaxed or waived to allow for loan modifications by lenders without the need to treat such loans as risky assets.

No developed country has enforced private loan forgiveness in any way, rather missed payments are accrued or capitalized. Higher loan repayments upon debt servicing resumption will therefore take effect in most cases, with maturity extensions allowed in a few cases to minimise any jumps in debt servicing costs. Late payment charges have been waived, and forbearance will generally not result in adverse credit score records. Payment holidays have been complemented typically with moratoriums on repossessions, security enforcements and evictions.

More layered moratorium rules in the UK reflecting more diverse loan types

In countries such as the UK with deeper alternative loan markets – namely to include specialist lending (mostly by non-banks) – the forbearance rules have been more nuanced to accommodate the diversity of loan types. For example, high-cost credit such as doorstep and payday loans have shorter payment moratorium allowances (one month), reflecting the disproportionate burden of interest roll-ups. And in the case of UK auto loans with put-back clauses based on residual values (PCP/ PCH contracts), there are added restrictions on lenders in making any adjustments to end-balloon repayment amounts during the moratorium window, while selected contracts maturing during the window may be eligible for residual principal cram-downs, namely when the borrower is a key-worker or the vehicle is deemed important for their livelihood.

Loan moratoriums are normally managed by regulated lenders, spanning banks and also regulated non-banks in many cases. Exceptions can include the likes of institutionally-funded marketplace loans and direct (asset management) lenders, though there is some evidence that the payment holiday practice has been nonetheless adopted for reasons of prudent borrower credit management.

Tactical take-up

While temporary payment holidays can often be an effective way to credit manage borrowers out of delinquency as an alternative to prematurely enforcing default, the wide-spread adoption of such practices during the covid crisis – led often by borrower demands rather than lender/ servicer strategies – will naturally see many borrowers behaving tactically in their take-up, likely irrespective of any debt servicing pressures. As a general rule, we feel broad-based moratorium initiatives are likely to invite strategic borrower behaviour, whereas prescriptive-based criteria may serve to limit take-up to those mostly in financial distress. To be sure, systematic forbearance will mask the extent of actual underlying credit weaknesses among borrower populations.

Immediate cash flow impact on private credit loan books

The cash flow disruption as a result of loan forbearance is a direct economic cost for private loan book investors, albeit a liquidity one for now. Therefore, unlike other policy actions that may mitigate the near-term impact of covid on the private and alternative credit markets, pre-emptive forbearance measures are poised to exaggerate the effects of the crisis, at least in the short-term.

Payment moratoriums compared

	Germany	Ireland	Italy	Netherlands	Portugal	Spain	Sweden	UK	USA
Basis	Legislative	None, voluntary agreement by major banks	Legislative	None, voluntary agreement by major banks	Legislative	Legislative	Regulatory	Regulatory	Legislative only for federal/ agency guaranteed loans
Obligor Types	Consumer & Micro-Enterprises only	Consumer & SME only	Mortgage & SME only	SME only	Consumer, Mortgage & SME	Consumer & Mortgage only	Mortgage only	Consumer, Mortgage & SME	Consumer Loans, Mortgage & SME
Eligibility Criteria	No prescriptive criteria, but subject strictly to evidence of direct adverse covid impact on livelihood. Excludes asset finance/ leasing for SMEs	No prescriptive criteria, case-by-case basis	Must be unemployed, or working on > 20% reduced hours or health-impacted in case of h/holds. Self-employed t/over must be down > 33%. No SME criteria. In all cases borrower must be <90d arrears, min 1yr loan seasoning. May incl leasing and CRE	No prescriptive criteria. For SMEs, company must be deemed in good financial health otherwise. For mortgages, borrowers will need to evidence direct adverse covid impact	Must be unemployed or health-impacted households. No criteria for SME. Borrower must be <90d delinquent, whether person or business	Subject to prescriptive criteria incl employment, relative household income and DSCR thresholds	No prescriptive criteria. Principal amortization holiday only	No prescriptive criteria. Borrowers typically self-certify adverse covid impact	No prescriptive criteria
Duration	3 months	6 months	6 months for SME, max 18 months for mortgage	3-6 months	6 months initially, extended indefinitely	3 months	16 months	1 month for HCSTC, 6 months for mortgages, 3 months otherwise*	3-6 months, except for agency mortgages (up to 12 months)
Interest	Accrues	Accrues	Not accrued	Accrues	Accrues	Not accrued	Accrues	Accrues, except for HCSTC	Accrues except for agency, federal student & SBA loans
Underwriting	Subject to lender discretion	Subject to lender discretion	Mandatory subject to eligibility compliance	Subject to lender discretion	Mandatory subject to eligibility compliance	Mandatory subject to eligibility compliance	Subject to lender discretion	Subject to lender discretion, save for mortgages where guidance seems quasi-mandatory (except where borrower is delinquent)	Subject to lender discretion for private loans, mostly automatic in case of agency mortgages, federal student & SBA business loans

Source: Integer Advisors, based on official public announcements. *FCA update announced on 19 June proposes a further 3 month extension for all consumer loans

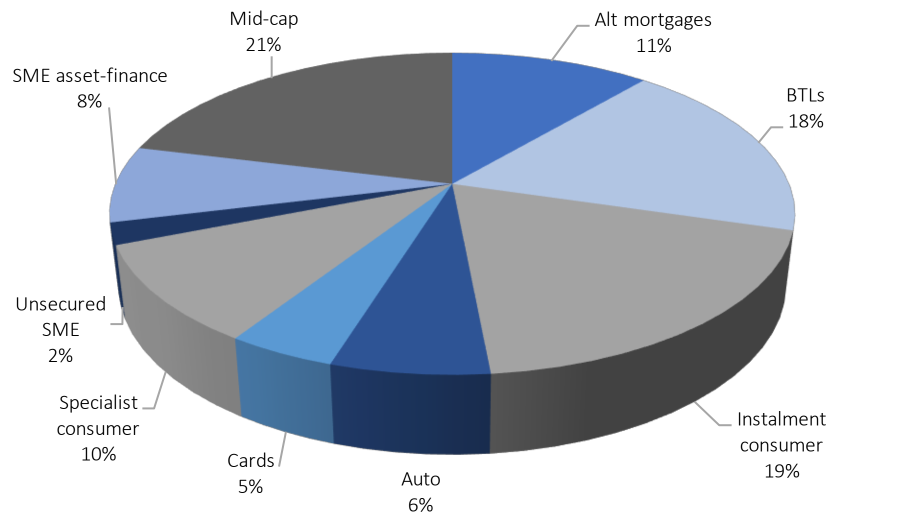
The Potential Credit Fallout on the Specialty & Private Lending Markets

Assessing the pandemic's impact on private credit performance is ultimately an analysis of the debt servicing capacity of households and small/ mid-cap corporates in the crisis aftermath, once forbearance options are exhausted and the exceptional fiscal (and to some extent, monetary) accommodation is tapered away.

- In the case of households, the ability to service debt upon its resumption will depend crucially on employment, in our view

- In the case of corporates, private credit performance will be correlated with the degree of business failures in the post-covid world, overlaid by the depth of refinancing liquidity, which typically plays a far more important role in corporate debt management than it does for household credit. With many real asset types (property, aviation, shipping, etc) facing devaluation risks as demand technicals are reset post-covid, there is the further potential for negative feedback loops into corporate credit performance, via both the willingness-to-pay and lower asset recoveries

How we think it breaks out – European non-bank, specialty credit market by asset type



Source: Integer Advisors estimates. Selectively include specialty assets of narrow, challenger banks

The first real test for servicing capacity and quality among non-bank lenders

Other factors such as servicing quality can also play an important role in loan book performance, particularly in downturn scenarios. We think servicing deficiencies may come to the fore as the crisis matures. Most non-bank lenders have only emerged in the past decade, during which time origination tended to be heavily invested in, rather than servicing. The covid crisis will be the first real test of the quality and adequacy of non-bank servicing functions. Moreover, social distancing and remote working may well impede loan servicing effectiveness.

Before we discuss the longer-term solvency risks related to the covid crisis, we consider the nearer-term liquidity impact of the crisis. By "liquidity" in this instance we mean the risks related to near-term mismatches between asset cash flow (impacted by forbearance and delinquencies) and on-balance sheet debt servicing / refinancing needs faced by certain lenders.

Specialty lenders face a liquidity / funding squeeze

Such specialty lenders are non-banks, whether fincos, marketplace or institutional direct lenders. Unlike for banks, there is generally no central bank liquidity support available to non-bank lenders in Europe, or indeed any other socialized funding facilities to serve the same purpose. (As mentioned above, the US and Australia are the only major exceptions in this respect). Capital markets remain restrictive for all but the blue-chip issuers. Many non-bank or specialty lenders in Europe have ceased new loan originations given the funding challenges. In the UK, for example, loan products on offer to non-prime borrowers fell 83% between the beginning of year and mid-May, according to study by ClearScore. A recent survey of UK non-bank lenders by PwC showed that half of such lenders anticipated funding gap pressures in the next 3-6 months.

Non-bank lender casualties seem inevitable

The near-term asset – liability cash flow squeeze has to-date been mitigated in some cases by external liquidity sources, mostly from financial parents such as private equity firms. Independent, stand-alone firms have had to rely on internal liquidity mostly (net margin reserves, namely) or, where possible, seek forbearance or waivers to borrowing base rules from bilateral lenders to mirror the payment moratoriums on the asset side. In due course, specialty lenders may further face equity recapitalization burdens as any facility refinancing will likely be structured more conservatively (lower leverage namely). Similar to what happened in the 2008/9 crisis, some lender failures are inevitable in our view, with loan books put into run-off or sold once step-in rights are enforced. Any extension of central bank facilities to directly support non-bank lenders or specialty credit assets would be very valuable in this regard, however we do not believe any such accommodation is forthcoming, not at least without many strings attached.

By contrast, securitizations have built-in protections against liquidity and refinancing risks

By contrast to such on-balance sheet liquidity risks, non-bank alternative assets financed through securitizations are typically structured with day-one cash/ liquidity reserves as well as structural provisions (for example, the temporary re-direction of principal flows) that can normally comfortably cover forbearance-based cash flow disruptions of up to 3-6 months. In terms of refinancing, non-bank securitizations coming up to soft maturities face non-call risks as many sponsors may not be able to tap the asset-backed markets currently – in such cases, the securitized bonds simply extend based on step-up coupons with the sponsor shut-off from any excess spread accruing to the securitization. There have been a couple of securitization non-calls in recent weeks and we would expect to see more such events in the coming months. Notably, bank-sponsored securitizations coming to market currently contain buy-back provisions for any loans in payment moratorium – such mitigation provisions are unlikely to be affordable for most non-bank lenders.

Compared to 2008, forced asset sales have been limited for now

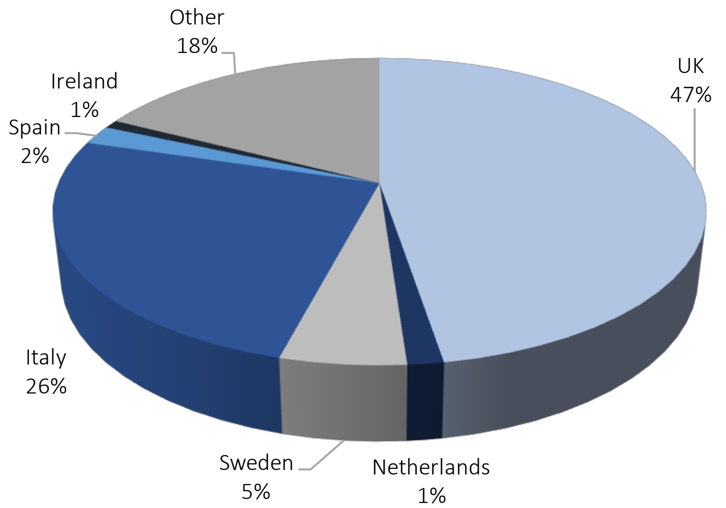
The near-term liquidity risks articulated above manifested recently in the case of asset owners with funding (leverage) against *tradable* loans or securities with observable prices. Margin calls on such repo and other funding lines saw the likes of CLO warehouses (very few however given the infrequent use of mark-to-market), listed specialist debt funds and other buyers of tradable ABS/ CLOs on repo forced into remedial actions, which often amounted to asset firesales. (The impact of margin calls was more noticeable in the US, especially among mortgage REITs). Such cases appeared limited in Europe however, and seem entirely absent since the recovery in asset markets. Indeed, the extent of forced sales on account of margin or funding calls have been far less prevalent in this crisis thus far compared to the events in 2008/9, which was fuelled by SIV unwinds, among others.

Consumer & Mortgage Credit

Alternative loan types, underserved borrowers, non-bank lenders

Non-bank originated consumer and mortgage credit in Europe typically spans alternative loan types and/or borrowers, ranging from off-the-run mortgages (including buy-to-let or BTL) to specialist consumer loans, originated to *both* prime and non-prime borrowers. Many non-banks – which span traditional fincos often owned by private equity to marketplace lenders funded by institutional investors – have used technology over the past decade to pioneer a more seamless borrower experience while offering differentiated loan products to compete for prime borrowers 'underserved' by the banking system.

The dominance of the UK in European consumer & mortgage specialty lending



Source: Integer Advisors estimates. Selectively include specialty assets of narrow, challenger banks

On our estimates, the overall lending footprint of non-bank, specialty household credit in Europe is around €240 billion, with the UK overwhelming dominating with a nearly 50% market share. By asset type, mortgages make up the biggest share by far, with UK BTL product the largest sector. The UK also has the deepest market for specialist consumer loans, ranging from non-captive auto financing and retail point-of-sale credit to higher-cost credit such as payday loans.

Payment and unemployment shocks will dictate ability-to-pay, in the near- and long-term, respectively

In assessing the potential credit fallout from covid on consumer and mortgage performance, we make the following key observations: -

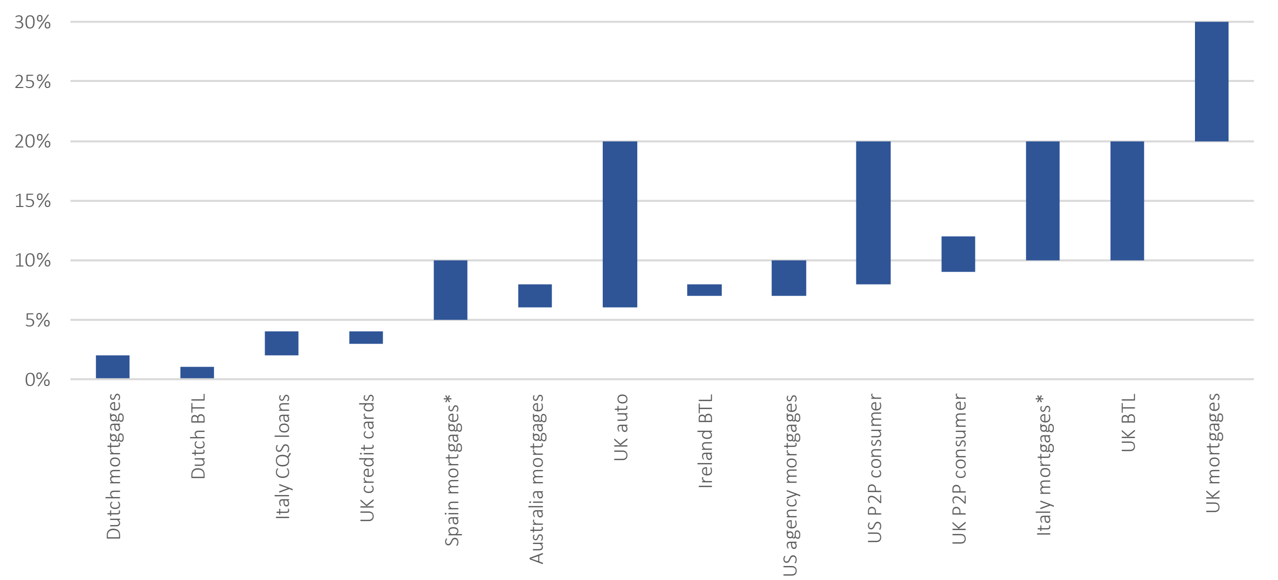
- Near-term performance will be dictated, in our view, by any debt repayment shocks relating particularly to borrowers emerging from forbearance periods to coincide with the tapering or outright removal of fiscal support measures

- In the medium- to longer-term, we feel unemployment will be the key determinant of borrower ability-to-pay. Unemployment related to the covid crisis will have a cyclical element as economies run at below capacity in the immediate crisis aftermath, and a longer-term structural dimension as economies adjust to post-covid demand realities. The consensus currently is for higher long-term unemployment rates than seen in the recent past, reflecting the likelihood of permanent economic 'scarring' from the covid pandemic.

We think affordability shocks will be limited as borrowers come out of forbearance

Over the nearer-term, we believe only a limited proportion of borrowers currently in payment moratoriums will face sufficient debt servicing strains so as to be delinquent. Foremost is our fundamental view that borrowers seeking loan payment holidays are not *all* in financial distress, with many – in our opinion – behaving tactically to offers of temporary payment relief. Crucially also, the current crisis has afforded most households a savings windfall, as fiscal measures have allowed incomes to be substantially maintained while discretionary spending has collapsed in lockdown. (The EC recently predicted that EU savings rates would increase 6% this year to 19%, with this trend also reflected in noticeable increases in households' bank cash balances). Loan payment holidays themselves afford further accretive effects on household disposable income. Moreover, interest rates have been cut, which should have transmission benefits for most floating-rate loans, save for the high-rate products such as credit cards and specialist loans. Debt affordability is therefore unlikely to be an *immediate* threat for many households coming out of short-term forbearance. Exceptions will include borrowers in prolonged payment holidays (Italian mortgages, for instance). Any tendency for European policymakers to extend loan moratorium periods should also be watched as risk flags, in our view.

Estimated forbearance take-up ranges (% of borrowers) among selected non-bank specialty consumer & mortgage lending

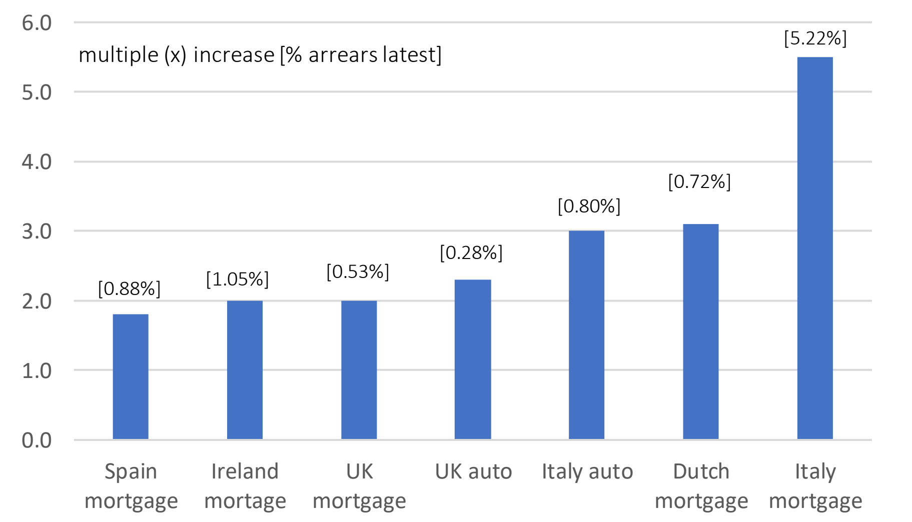


Sources: Securitization remittance reports, listed lender statements, official data, Moody's, MBA (US), dv01 (US). *Includes experience of banks

Delinquency upticks visible in a few markets

Judging by available data gleaned from listed lenders, securitization reporting and asset finance trade bodies, we see forbearance rates ranging widely by jurisdiction and asset type. (See chart above). The UK and Italy, for example, have witnessed greater take-ups compared to the likes of the Netherlands. Perhaps not coincidentally, available securitization remittance data show specialty consumer loan books in UK and Italy – and Spain – exhibiting recent drifts higher in delinquencies. The self-employed and other 'complex income' borrowers look to be disproportionately responsible for the higher arrears, as evidenced by recent EDW analysis. (See chart below). Except in Italy, mortgages look more resilient generally, to notably include buy-to-let loans which have shown little change in borrower payment behaviour thus far. Credit performance among non-bank mortgages in countries such as the Netherlands, Sweden and Ireland also remain solid for now.

What mainstream loan books show in terms of self-employed borrower (under)performance measured by difference in early stage arrears pre- and post-covid



Source: European DataWarehouse. Represents ECB eligible securitizations mainly from banks and captives

Higher, persistent unemployment poses the greatest risk to credit performance in the longer-term

The longer-term picture is more mixed, in our view. Key to any analysis in this respect would be the default behaviour as longer-term unemployment takes hold, whether such defaults come from the roll-rate of borrowers in moratorium or any other credit migrations. At this stage it is unclear to most as to the duration and ultimate severity of labour market adjustments to the covid crisis, much of which depends on when, or indeed if, economies return to full normality. Most forecasts point to unemployment reaching roughly the same levels seen in the peak of the 2008/9 crisis. Based on the conservative view that such unemployment peaks remain persistent over the longer-term, we would make the following credit performance observations: -

Residential mortgages should prove the most defensive …

- Residential mortgages should emerge the most defensive asset type, in our view, based not least on the textbook theory that households will naturally prioritize mortgages over any other debt obligation. Mortgages are also typically benchmarked to official rates, and therefore debt servicing costs would unlikely to ever be lower than in the covid era. We think it reasonable to predict that mortgage defaults reach similar peaks seen in the aftermath of the 2008 crisis. Annualized mortgage default levels peaked at less than 0.2% in core European markets like the Netherlands, ranging upwards to 0.5% in the UK and to nearer 1% p.a. in more deeply distressed real estate markets like Spain. (Defaults in Ireland were much higher but the housing market implosion was exceptionally brutal, even by any likely covid standards). The cumulative erosive effects of losses-given-defaults of this scale on mortgage portfolio valuations is unlikely to be materially significant, in our view. There may be exceptions of course

… but specialty auto loans less so

- Secured consumer credit such as auto loans will naturally experience higher defaults in the longer-term, with loan rates tending to be fixed and refinancing options limited, especially against the likely backdrop of depressed second-hand car values. The latter dynamic poses a particular threat to residual value-based finance products (for example PCP in the UK), given the lender exposure to unexpected asset devaluations not priced into terminal residual values

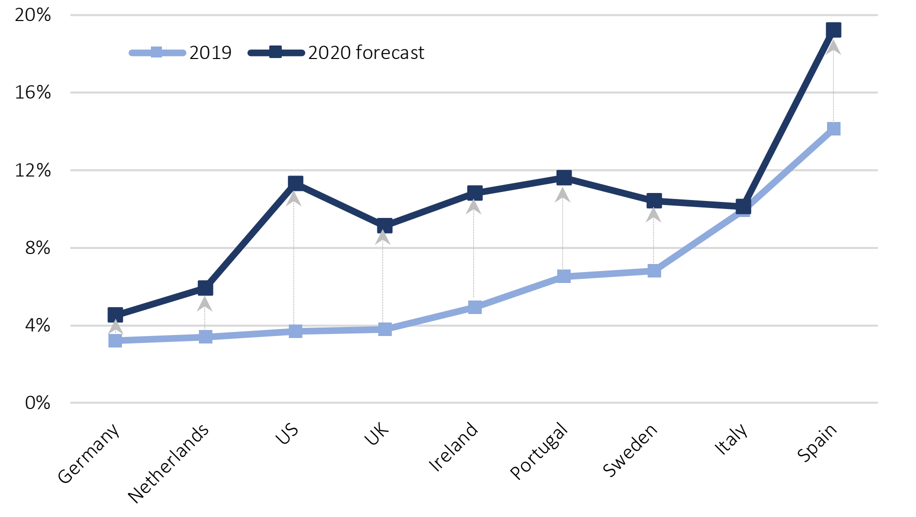
Unsecured consumer credit looks to be the most vulnerable

- We think unsecured consumer credit, whether instalment loans or credit cards, will bear the brunt of any post-covid financial distress among households. This is borne out also by bank impairment expectations for retail non-mortgage loan books, which – as of April – foresees loss charges (provisioning and/or IFRS9 stage 3 classifications) increasing 3-4x relative to pre-covid expectations. By contrast, anticipated losses in mortgage portfolios have typically increased no more than 2x. In the recent BoE desktop stress tests, for example, UK banks were deemed as facing potential increases in consumer credit impairment rates to 15.5%, versus 0.4% for mortgage loans. We believe specialty (non-bank) consumer credit trends would not be any better than what the banks are facing, likely worse.

Margin-rich loan books should be better insulated than in previous credit-fuelled crises

We would make one further remark that we feel is worthy of note. Reflecting our earlier view that the covid crisis is unique given its near-universal, uniform economic impact, we would hypothesize that – unlike previous credit-fuelled crises – the impact this time around may *not* be disproportionately concentrated in non-prime or alternative borrowers. Our point here is that margin-rich loan portfolios may be better insulated in the coming downturn relative to past credit crises, with the higher loan yields proving adequate from a risk-adjusted perspective. In Europe, such mid-/ high-cost consumer credit is limited largely to the UK, and to a lesser extent in Sweden and Ireland. Loan types span non-prime auto financing to retail point-of-sale credit to short-term lending such as doorstep credit, payday and guarantor loans. We would caution that certain HCSTC lending in the UK faces potential regulatory risks that may threaten their viability, irrespective of any covid impact.

Unemployment shocks expected in a few economies



Source: OECD

Small-/ Mid-Cap Corporate Credit

A diverse market in Europe

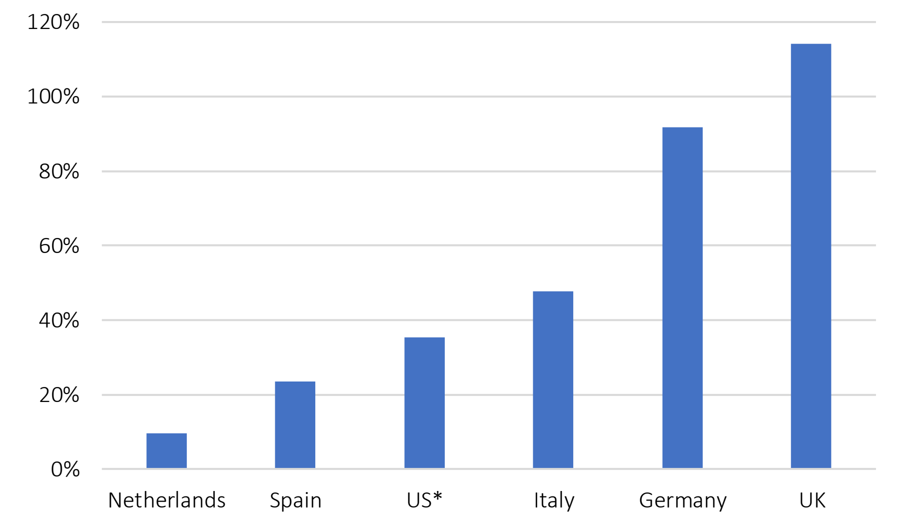
Non-bank SME and mid-cap corporate lending in Europe is a diverse universe of borrower and loan types. Unlike consumer or mortgage markets, the UK is not dominant, with such lending spread across Europe. Distinguishing between mid- and small-cap lending, we make the following observations: -

- Mid-cap lending accounts for more than two-thirds of non-bank corporate lending stock by our estimates, dominated by a new post-2009 generation of institutional (asset management-based) direct lenders, otherwise branded as private debt funds. By all accounts, lending to mid-caps looks to mostly mimic the lending discipline in the larger-cap leverage finance market, in terms of financial structures, gearing, covenant use and so on. The key difference is (still) the bilateral, non-syndicated nature of European mid-cap lending, which generally affords private debt funds greater control

- Non-bank SME financing remains relatively small by comparison, amounting to ca.€35-40bn by our estimates. To be sure, banks continue to overwhelmingly dominate SME financing in Europe. Non-bank lending activity spans specialised asset finance – such as invoice, leasing and CRE-backed lending – to more vanilla term unsecured loans. Direct lenders have some presence in SME markets, however lending is generally dominated by fincos mostly, with marketplace platforms also having a notable presence.

We exclude large-cap corporate lending, to include leveraged finance, from our proceeding analysis, but refer to the latter as a proxy where useful. Non-bank leveraged finance in Europe is dominated by CLOs.

The SME bazooka – government funding/ credit guarantees as % of SME loan stock



Source: Integer Advisors calculations based on IMF intelligence. (Note may include modest overlap with non-SME corporate credit). *US data includes the Fed's Main Street Facilities

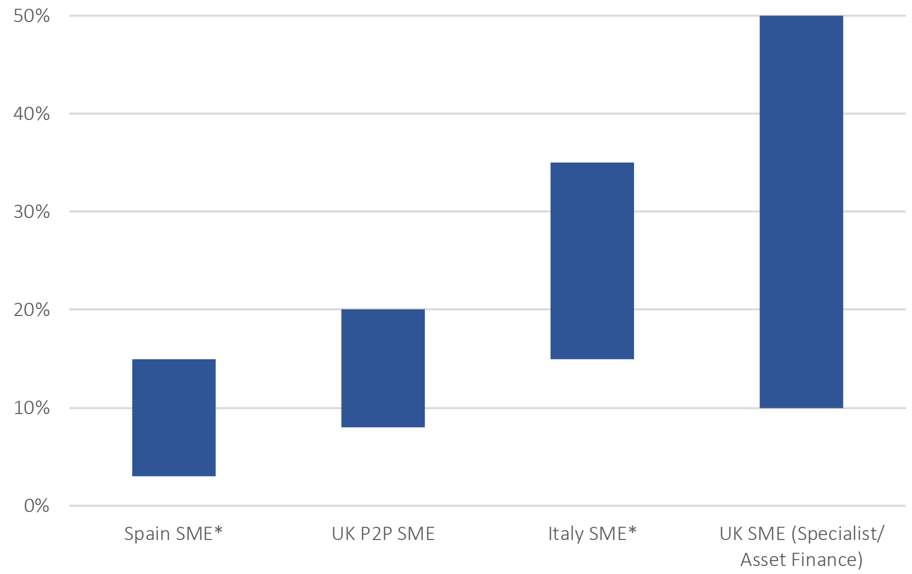
Low-cost government loans (often without any underwriting) and grants, tax holidays and – in a few jurisdictions – the ability to furlough or temporarily lay-off employees at substantially no cost have comprised the fiscal response with respect to corporate economies. Certain corporates such as SMEs and micro businesses have also been able to readily seek rent holidays as well as loan forbearance, the take-up of which has ranged from 10-40% in most European countries, higher in the case of UK specialized asset-financing to the extent observable. (See chart below)

Government loans may prove a useful – albeit limited – default mitigant in the near-term

But unlike affected households who have had wages paid for directly by the public purse, businesses have had to mostly *borrow* from governments in order stay afloat during the lockdown. The seniority of such government lending has seldom been fully spelt out from what we have been able to tell (except in the US where some federal loans take timing priority in repayment while others explicitly allow for forgiveness ultimately, subject to terms), with this point being crucial in assessing corporate credit risks in the immediate covid aftermath, in our opinion at least. We believe most companies will treat government loans as generally subordinate to private loans in the context of debt servicing priorities going forward. Coming out of forbearance periods, businesses may therefore be motivated – where possible – to paydown higher-cost private debt and rely instead on lower/ zero-cost government loans and grants, indeed directly refinancing private-for-public debt wherever allowed. (Few countries like the US explicitly prohibit the use of proceeds to redeem private debt). Such credit behaviour will of course be supportive of private credit performance in the near-term, as the balance of default risks shift from private to public credit.

But there are important caveats to note. Government loans for businesses are often capped by their amounts (nominal or turnover-based thresholds typically) and almost always subject to borrower eligibility, usually limited to non-financial, non-real estate companies, in some cases isolated to the smaller-cap corporate economy only. Such loans also come with restrictive covenants normally aimed at minimizing any 'gaming' risks, aside from protecting employees. Ultimately, we think government funding may play a role in moderating, rather than fully mitigating, the potential default shock facing *some* corporate borrowers in the immediate covid aftermath.

Estimated forbearance take-up ranges (% of borrowers) among selected SME lending markets



Source: Listed lender/ fund statements, Moody's, *Includes experience of banks

But the longer-term economic reality paints a more bearish picture

The longer-term picture for corporate credit performance is notably bleaker, in our view. Until a return to full normality, demand in many industries and sectors can be expected to retrench post-covid, while operating models are likely to remain under significant pressure. Bankruptcies and defaults are likely to test historic records. Notwithstanding the currently generous economic incentives for banks to lend to the likes of SMEs, we believe refinancing liquidity will remain tight for most specialty credit borrowers, not least as the incumbent non-bank lender base retreats under the funding squeeze.

SME markets may potentially exhibit widespread vulnerability to the covid fallout. Unsecured business loans and mid-cap corporate credit deserve mention within the context of non-bank lending, in our view: -

Unsecured SME credit looks most at risk

- Unsecured loans will naturally be the most exposed in any corporate distressed scenario. Indeed, data on UK marketplace loan book performance shows arrears having increased significantly already from April, as have delinquencies in Italian SMEs, forbearance rates in which are among the highest in Europe. (See chart above. Moody's recently cited that Italian SME moratoriums are already almost twice the rate seen after the 2008 crisis). Listed lenders (banks mainly) have provisioned generally for a 5-8x jump in SME losses related to covid, judging by statutory reports published in recent weeks. Specialty non-bank unsecured loans can be reasonably expected to experience similar spikes in defaults, indeed arguably at the higher end of the range given the likelihood of some adverse selection in the previous lending cycle. Any such spikes could potentially drive non-bank unsecured corporate loan defaults to a peak of 10-20%. With these loans typically priced at mid to high single digit yields in Europe, and up to the low teens in the UK, any default experience of that scale would noticeably impair loan book par values. (We assume zero recoveries)

Mid-cap lending may also be vulnerable, in what will be the very real test for private debt funds

- Mid-cap corporates may not fall neatly within the fiscal and monetary stimulus envelopes of some country policy responses to covid, which tend to be bar-belled in its targeting of SMEs only on the one hand, and large, rated corporates on the other. Sponsored mid-cap loans are particularly at risk in this respect, as EU state-aid rules (still applicable also to the UK) disallows any government-related lending to companies with accumulated losses exceeding 50% of share capital, which is deemed as a sign of distress – however, PE-owned companies are often captured by this exclusion given the tendency to run businesses on high gearing and inflated losses. There is little transparency around the performance of mid-cap portfolios managed by direct lenders to judge borrower performance currently. As a proxy, we look at the large-cap leveraged finance market – rating agency default expectations for leveraged loans over the coming cycle range from 8-10%, levels which would be inside of default peaks reached in the 2008 crisis (closer to 13%), despite the fact that the pace of downgrades among loans seen in the past three months has already surpassed the rate witnessed in 2008/9, according to S&P. Even if mid-cap loans experience default rates at the lower end of this range – an assumption that may be merited given stronger lending standards in some cases (in terms of gearing, covenants, etc) compared to large-cap leveraged loans – ultimate losses may still look significant relative to par loan yields, which in the case of mid-cap, non-special situation lending, tends to clear in the 5-7% range. Credit-led margin calls may accelerate such loss recognition, however we understand few direct lenders in Europe employ fund- or loan-level leverage. Unlike fincos, direct lending funds are not generally exposed to any other maturity transformation risks.

  Leveraged loan prices are in the high 80s to low 90s levels currently, while valuations as implied by CLO prices suggests even deeper discounts-to-par. As another yardstick, the NAVs of US BDC portfolios – which are typically dominated by mid-cap loans – have fallen by up to 10-20% since the onset of the pandemic. We believe European mid-cap portfolio valuations are unlikely to be entirely decoupled from such trends among peers, though there are no observable market prices to evidence this of course.

Selected secured SME credit may be better placed, but not all

Within the alternative corporate credit space, we believe secured loans – selected leasing and vanilla asset finance – would generally outperform over the coming cycle. But there will be exceptions. The covid crisis may take a heavier toll on receivables and invoice financing in the near-term reflecting supply chain dislocations. Recent anecdotal evidence suggests that 10-15% of businesses have withheld supplier payments in order to deal with the current cash flow squeeze. Another important exception would be real estate-backed corporate lending, including development finance. Commercial real estate finance in general is facing an unprecedented valuation test on account of covid, triggered by the collapse in near-term demand and rental cash flows. Save for logistic assets, few real estate types appear immune at this stage. The CMBS market provides a useful early-warning lens in this regard – the market has witnessed a sharp increase in rating downgrades given the extent of rent moratoriums and/ or covenant breaches, with retail and hospitality assets most affected. (Delinquencies among US CMBS loans – data for which is more comprehensive – increased from 2.3% in April to 7.4% in May, according to Trepp, driven by retail and hotel exposures). A fuller analysis on CRE loan performance is outside the scope of this report, but suffice to say we remain bearish on this asset class.

NPLs face unprecedented challenges

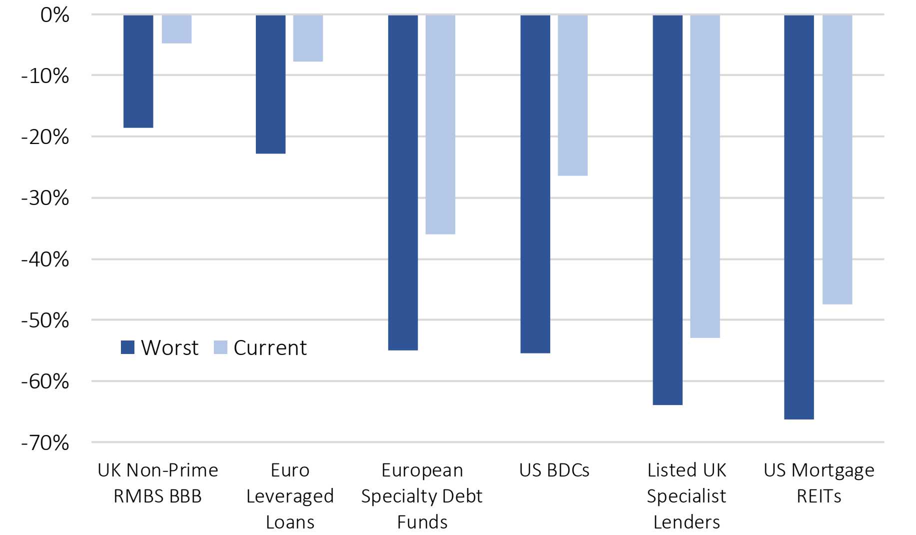
NPL back-book portfolios warrant a final mention. We expect covid to take a particularly heavy toll on such secondary portfolios, which are mostly owned by specialist investors and funded via bank facilities or securitization outlets. Debtor protection measures, to include enforcement and repossession moratoriums, have radically disrupted the cash flow outlook, with the timing and quantum of recoveries facing the greatest uncertainties since the inception of this private market some ten years ago. Business collection plans established in recent years may need to be radically diluted, with very few exceptions.

Alternative Credit 3.0: Private Market Opportunities in the Covid Aftermath

Opportunities from forced selling proved limited

The immediate investment opportunities early in the covid crisis were trading related with a few asset owners forced into selling tradable loans and securities subject to margin calls. (The few CLO warehouse unwinds included). Such trading opportunities presented by price dislocations proved short-lived, however. We think the next window of trading opportunities – aside from any sharp or prolonged renewed sell-off to come – may be led by de-risking by financing and warehouse providers, securitized credit vehicles and funds (including CLOs again) as ratings downgrades and/or credit deterioration trigger fresh margin calls and portfolio rebalancings. As a case in point, the average CCC exposures of Euro CLOs had already more than tripled to 7.9% by end-May from 2.3% at end-Feb, according to Fitch.

The brutal sell-off in listed instruments related to specialty non-bank credit – price declines from early 2020 peak to crisis worst and current levels



Source: Integer Advisors calculations, Bloomberg, S&P LCD. US BDCs and Mortgage REITs based on ETFs

Non-bank lender liquidity/ funding distress to underpin back-book opportunities in the near-term

As for 'stickier' private credit/ loan book opportunities, the coming months may see similar pressures emerge among specialty lenders unable to tap fresh sources of liquidity, financing and/or equity. Non-functioning lenders but with performing loan books – which may include the likes of alternative mortgages and potentially even some higher-cost consumer credit, based on our preceding arguments – can be a compelling recipe for value. Such back-book opportunities may manifest in a manner of ways: -

- Providing liquidity to lenders managing temporary loan repayment moratoriums
- Loan book senior or mezzanine funding, allowing existing funding providers (often warehouse banks) to de-risk
- Private refinancing of selected ABS/ CLOs at the point of step-up calls

- Recapitalizations or outright acquisitions of specialty loan books of failed lenders, or the lending platforms themselves. (Inheriting superior technology-led lending infrastructures, which many non-banks have built over the past decade, may appeal to certain investors).

Similar to post-2008 trends, we believe that in the near-term the specialty lending market will witness some trading of loan books orphaned by failed lenders, in some cases via outright lender acquisitions. Established, well-capitalized private investors are likely to take greater ownership of such asset markets as the industry consolidates around the survivors. We expect also to see banks selectively exploiting the opportunity to take back market share via back-book and/or lender acquisitions, particularly in prime, vanilla assets. (Exceptional funding facilities and capital holidays will likely fuel such bank appetite). Indeed, re-intermediation may be a theme in the near-term as banks exploit their balance sheet superiority at a time when non-bank lenders are likely to retrench under the burdens of the covid crisis.

Alternative credit 3.0

Over the medium- to longer-term we see opportunities rotating into front book lending as and when economies emerge from the pandemic crisis. Low barriers-to-entry have allowed non-bank alternative lending industries to re-develop almost seamlessly following crises, seeded by both existing and new forms of capital. We think it will be no different this time around. Indeed, the revival of private/ alternative credit markets may be quicker under a V-shaped recovery, a view being telescoped by risk asset markets currently. Whenever the revival, we would highlight the following key factors: -

- Banks can be expected to return to a more constrained lending model post-covid, motivated by the need to risk-manage balance sheets and rebuild capital buffers. This should, again, create a natural gap for non-bank lending to fill. Such front-book lending will also likely be driven by the resumption of demand for non-bank credit, not least as the post-covid population of speciality borrowers expands

- Unlike the aftermath of the 2008 crisis, when European governments took significant ownership of legacy or back-book bank assets (often non- or sub-performing), the covid crisis will see governments as owners of *front-book* credit assets, namely the newly originated subsidised loans provided to corporates during the crisis. The question then is if this de facto nationalisation of segments of the loan markets anchors a longer-term role for public money in credit lending. (The US mortgage market is an example where the increased role of GSEs following the 2008 crisis arguably crowded-out non-agency lending over the next decade). At this stage we believe governments will be more incentivized to expediently *reduce* the burden of credit ownership as public debt levels test new record highs. ‘Crowding-in’ private credit supply – including alternative forms of finance – would seem, to us at least, as a prudent way to wean borrowers off public credit.

Compelling risk-returns early in the next lending cycle …

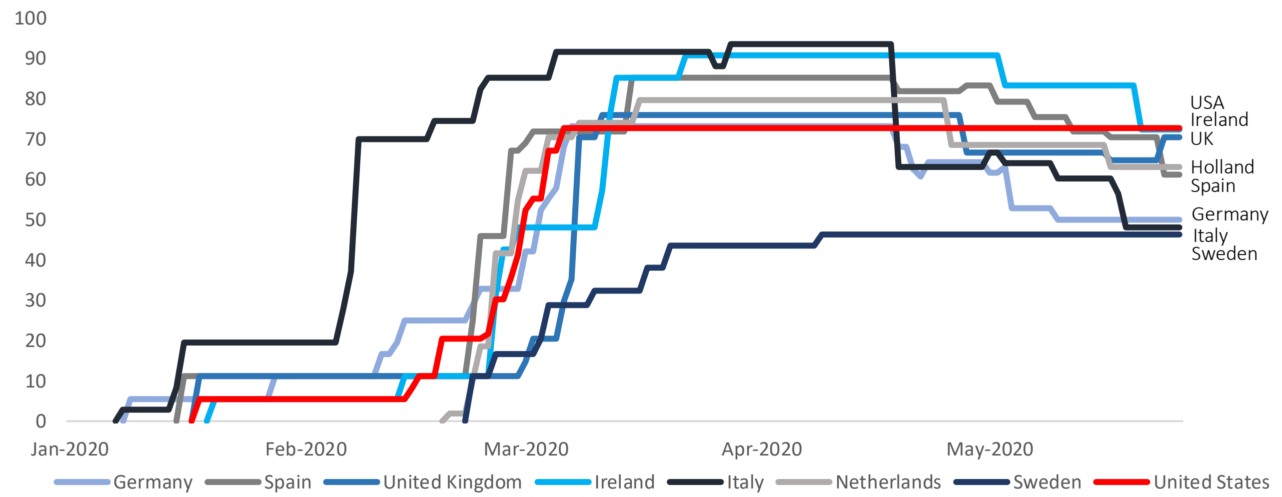
Private credit lending/ investment appetite in the covid aftermath can be expected to be fuelled also by very compelling risk-returns relative to the recent past. Consistent with the dynamics in most early-cycle lending, freshly originated loans would normally be more defensively underwritten compared to late-cycle lending (lower gearing/ LTVs, tighter covenants, better quality borrowers, etc). Yet front-book specialist or alternative loans would typically price at rich margins in the early stages of any credit cycle recovery, evidenced certainly in the aftermath of both the 2008 as well as the 2000/1 leverage finance crises.

… especially in the context of ultra-low rates

More fundamentally, ultra-low rates over a prolonged duration should further entrench the merits of private credit or whole loan investing, indeed the liquidity give-up (or alternatively, the immunity from marking-to-market) will likely appeal all things considered. For loan book (equity) owners, the normalization of securitization and other institutional funding markets should provide ultimately for compelling leveraged returns.

The covid crisis has also evidenced policy-maker appetite to backstop catastrophic, tail-like risks in the real economy. (A policy 'put', as it were). Described differently, households and small businesses can now be collectively considered as "too-big-to-fail", just like banks were in 2008. We feel this will have bullish overtones for private and alternative credit investing fundamentals going forward.

Easing out of the lockdown, but nowhere near back to full normality. Ranking lockdown 'stringency'



Sources: Blavatnik School of Government, Oxford University.

Note: The Stringency Index shown shows the degree of countries' containment and closure policies *only*, ranked up to 100 (most stringent). The index should not be interpreted as scoring the appropriateness or effectiveness of a country's response

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