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**EDITOR'S NOTE: NEW RULES?**

Victoria Prussen Spears

**WILL WE HAVE NEW RULES FOR CORPORATE BANKRUPTCIES?**

**RECENTLY PROPOSED LEGISLATION THAT COULD REFORM CHAPTER 11 PRACTICE**

Matt Barr, Lauren Tauro and Furqaan Siddiqui

**NON-PERFORMING LOANS THROUGH THE ESG LOOKING GLASS:**

**APPLYING ESG CONSIDERATIONS TO THE CREATION OF A NEW TYPE OF  
INVESTMENT OPPORTUNITY FOR CREATIVE INVESTORS**

Andrew Petersen and Anna Nolan

**NEW YORK AMENDS CONTACT REQUIREMENTS FOR CERTAIN DELINQUENT  
BORROWERS**

Morey Barnes Yost

**COUNTRY DANCING IN THE BANKRUPTCY COURT: THE "TEXAS TWO-STEP"**

Michael J. Lichtenstein

**IN VACATING PURDUE PHARMA'S CONFIRMATION ORDER, DISTRICT COURT  
DETERMINES THAT PLAN'S NONCONSENSUAL THIRD-PARTY RELEASES ARE NOT  
STATUTORILY AUTHORIZED**

Jessica Liou and Brian Morganelli

**FIFTH AND SIXTH CIRCUITS REJECT INEXCUSABLE LATE FILINGS**

Michael L. Cook

**TWO RECENT CHAPTER 15 CASES CLARIFY JUST HOW LOW THE BAR IS FOR  
RECOGNITION**

Laura E. Appleby and Kyle R. Kistinger

**BANKRUPTCY BRIEFS**

Michael R. O'Donnell, Michael Crowley, Desiree McDonald and Kevin Hakansson



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VOLUME 18

NUMBER 4

June 2022

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**Editor's Note: New Rules?**

Victoria Prussen Spears 151

**Will We Have New Rules for Corporate Bankruptcies? Recently Proposed Legislation That Could Reform Chapter 11 Practice**

Matt Barr, Lauren Tauro and Furqaan Siddiqui 154

**Non-Performing Loans Through the ESG Looking Glass: Applying ESG Considerations to the Creation of a New Type of Investment Opportunity for Creative Investors**

Andrew Petersen and Anna Nolan 163

**New York Amends Contact Requirements for Certain Delinquent Borrowers**

Morey Barnes Yost 173

**Country Dancing in the Bankruptcy Court: The "Texas Two-Step"**

Michael J. Lichtenstein 176

**In Vacating Purdue Pharma's Confirmation Order, District Court Determines That Plan's Nonconsensual Third-Party Releases Are Not Statutorily Authorized**

Jessica Liou and Brian Morganelli 183

**Fifth and Sixth Circuits Reject Inexcusable Late Filings**

Michael L. Cook 188

**Two Recent Chapter 15 Cases Clarify Just How Low the Bar Is for Recognition**

Laura E. Appleby and Kyle R. Kistingner 192

**Bankruptcy Briefs**

Michael R. O'Donnell, Michael Crowley, Desiree McDonald and Kevin Hakansson 195

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# Non-Performing Loans Through the ESG Looking Glass: Applying ESG Considerations to the Creation of a New Type of Investment Opportunity for Creative Investors

*By Andrew Petersen and Anna Nolan\**

*The authors explore why a marriage of the non-performing loan market and the environment, social, and governance market provides rich opportunities for savvy investors.*

As the world emerges from the COVID-19 pandemic and begins to embrace and address the economic and societal challenges that have been presented, and in some cases accelerated, by the greatest global public health crisis in living memory, a number of challenges face our financial markets—not least of which is to address the onset of inflation and the impact of the withdrawal of governments’ and central bodies’ fiscal stimuli that effectively saw our European loan portfolio markets suspend activity and that will lead to a consequential lag effect of economic shock.

Political risks could significantly increase the levels of non-performing loans (“NPLs”). For instance, the Ukraine crisis has driven up global energy prices (oil and gas prices are soaring). Some financial institutions have exposure to Ukraine, Russia, and Belarus and, therefore, need to ensure that they comply with the new sanction regimes. It remains to be seen what the actual impact of the Russia-Ukraine conflict will be on the NPL levels in Europe. But we expect that the Ukraine crisis combined with rising inflation, the supply chain crisis, and the prevailing uncertainty will result in an increase in non-performing exposures over time.

In addition to the increasing political risks, the threat of rising inflation (alongside the threat of real interest rates possibly remaining lower than needed to control inflation) will lead to increased volatility in our financial markets and investment decisions that search for yield and seek out value-add products to generate increased returns. The search for yield and volatility could be combined with a wave of possible defaults and insolvencies (threatened for so

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many years) across Europe, and the prospect of many financial institutions and banks across Europe having to delever their risk to their stressed or distressed portfolios (especially those banks that have been slow in prudently marking down the value of their portfolios) could result in NPLs being viewed in a different light and a gradual increase in loan portfolio sales and investors that have targeted NPLs in the past facing a busy and opportunistic few years.

This is nothing new. But what is of interest is how those loan sellers can market their loans when embarking on a deleveraging process and how those loan buyers can deploy capital in a way that results in an expected return on that capital for them and their investors. Those investors may not have targeted NPLs in the past due to the reputation of NPLs and not having the creative mindset to distribute capital in a way that enhances values and deals with the constant threat of stranded assets brought about by the momentous investor demand to reduce the carbonization of our portfolios and deploy capital based on environment, social, and governance (“ESG”) considerations.

The world of NPLs is on a journey to consider if the worlds of NPLs and ESG can collide in a way that creates a rich vein of opportunity for investors, loan sellers, loan buyers, and those that may own or manage stranded assets over which there is a large portion of secured debt.

## THE TRADITIONAL EUROPEAN NPL MARKET

According to Deloitte’s Deleveraging Europe 2021 report,

- Portfolio markets went into deep freeze in early 2020; even with some markets renewing deal activity in the second half of the year, deal volumes dropped 60 percent.
- Italy (€44 billion of transactions in 2020) and Greece (€12.4 billion) drove European deal volumes in 2020 largely using government-guaranteed NPL securitization schemes. Both countries demonstrated good levels of NPL portfolio sales in H2 2020, driving improved NPL volumes and ratios.
- The average NPL ratio across European Banking Authority (“EBA”) banks has continued to fall (to 2.6 percent at the fourth quarter of 2020), reflecting a reduction in NPL volumes, unprecedented levels of government stimulus and regulatory forbearance measures, and a rise in total loans and advances.
- Since the start of the pandemic, €900 billion of European loans have received support through EBA-eligible moratoria, of which 70 percent were granted by banks in France, Spain, and Italy, making these

jurisdictions potential hotspots as measures unwind.

- Despite overall declining trends in total NPL volumes across Europe, repeated lockdowns and the level of loans still under loan moratoria mean that higher new NPLs are widely expected and may reach peaks not seen since the global financial crisis.
- In anticipation of a deterioration in asset quality, the largest European banks covered in this report provisioned €118.1 billion in 2020, more than double 2019 levels of €54.5 billion. Banks are, however, starting to tail off or reverse provisions given growing confidence from asset quality improvements and macro recovery.
- Legacy portfolios, where disposal processes were paused due to the pandemic, are likely to be the first brought back to the market. So far in 2021, transactions totalling €29.1 billion have closed, with an expected additional €70.2 billion in the pipeline for the year, bringing it close to 2019 levels of €119.2 billion.

All of the above, we would argue, presents tremendous opportunity for loan sellers and loan buyers in 2022 and beyond—it is clear that the NPL securitization and sales market is set to grow in Europe and may become a central target for those investors that want to take advantage of the economic situation that COVID-19 has been a catalyst for, especially when one considers this opportunity in light of the ESG movement we have seen over the last few years.

## THE GROWING EUROPEAN ESG INVESTMENT MARKET

Even though the securitization market has been slower to adapt to the trend to focus on ESG considerations, largely due to the complex nature of the market, investor interest in ESG is growing and the securitization market is evolving quickly across products, such as asset-backed securities (“ABS”) and residential and commercial mortgage-backed securities (“RMBS” and “CMBS,” respectively), with increasing green, social, and sustainability issuance, for example, where the underlying collateral positively impacts housing infrastructure and the environment and meets energy- and water-saving standards. Many deals refer to the International Capital Market Association’s green, social, and sustainable principles or the United Nations Sustainable Development Goals.

Investors are also looking more closely into not just the “E” in ESG but the “S” as well—what is the societal impact of making the investment? Sustainable investing is an investment category that incorporates ESG factors into investment decisions to better manage risk and enhance long-term returns for investors. In recent years, largely due to the demand of institutional investors,



ESG considerations have become increasingly important among all stakeholders and investors in key asset classes, including leverage loans and bonds. In some respects, the trend outlined above can be distilled into two words: “risk management.” As ESG has become an increasing issue for credit quality, and financial market stakeholders and investors have identified a growing number of ESG-related risks, the question has been asked about how such ESG risks may be measured, and how financial market stakeholders and investors are increasingly trying to reduce their exposure to such ESG risk in the products they invest in.

But as well as risk management, it is clear that such demands are also underpinned by a desire to have a more positive environmental and societal impact. High ESG standards are increasingly critical to a financial institution's reputation and its license to operate. Banks are facing intense public scrutiny over the impact of their lending practices on human rights, social cohesion, gender equality, carbon emissions, biodiversity, and other ESG topics. Activist investors and stakeholders and environmental groups are working on shareholder and stakeholder resolutions that single out banks for poor ESG practices. A lack of ESG consideration can cause a lot of damage to someone's reputation, but a well-thought-through ESG strategy can give rise to new revenue streams.

According to a report issued by Covenant Review in October 2021, ESG margin ratchets were present in 53 percent of new European leverage loans in the third quarter of 2021. It is a significant share of the European leverage loans market, given that the first broadly syndicated, primary issuance, European leveraged loan containing an ESG margin ratchet was recorded by Covenant Review in June 2020. And while the European leveraged loan market has not yet seen a pricing differential between transactions that include a margin ratchet linked to ESG-related criteria, it's only a matter of time before the brown discount becomes such a size that it affects investors' interest, and so investor interest in green and sustainability-linked bonds will continue to grow. Such bonds may further come with increased tax incentives (tax exemption and tax credits) to enhance their attractiveness.

## **CAN INVESTORS GENERATE REVENUE FROM NPLS REINVENTED IN COMPLIANCE WITH ESG PRINCIPLES?**

NPLs are loans with payments of interest or principal more than 90 days past due or where the lender determines that the borrower is unlikely to be able to make its scheduled payments. Essentially a distressed loan.

Given the development of ESG considerations, we believe that ESG issues are capable of reaching all asset classes (including distressed loans) and become

core to any investor's approach to managing and improving performance of loans that are regarded as distressed.

The combination of NPLs and ESG is a novel issue, but we anticipate that over time, the traditional type of distressed investors and credit opportunities funds will start thinking about ESG across all asset classes, including NPLs, and the two will become a perfect fit for dealing with some of the stock and loans secured by challenging existing buildings as we move towards 2050.

## **HOW DISTRESSED LOANS AND ESG CAN WORK TOGETHER**

There is a lot of distressed debt in the hands of lenders following the COVID-19 pandemic, and there is also a lot of dry powder that needs to be deployed, but everyone is seeking product and the available opportunities are limited. This new opportunity presents a solution to the problem of a limited pool of opportunities and could be attractive to green buyers and green sellers. But how would that work in practice?

### **Case Study: Project Mercatus**

In the UK in 2021, NatWest sold a £400 million portfolio of shopping-centers loans. NatWest believed that the winning buyers will collectively be able to support the long-term potential of these shopping centers, with NatWest achieving its aim to secure a buyer that is good for both the customers involved and the communities these shopping centers serve. There will no doubt be an underlying societal benefit injected into the repositioning or repurposing of the underlying retail assets, including the debt secured thereon, as the shopping centers could be repossessed by the new lenders, or alternatively the NPL lenders could focus on working with the NPL borrowers and asset managers to develop long-term ESG-compliant solutions to increase the value of the assets and improve the functioning of the borrowers' businesses. This could require funding, which could be provided by a co-investor or another financing provider working with a borrower to improve the asset—maybe Opex or Capex facilities are offered—maybe before a refinancing or repayment based on a sale of the asset.

One can easily see that projects involving turning existing grey or brown buildings owned by NPL borrowers into renovated and energy-efficient less grey or less brown or even green buildings (investments in energy efficiency, shift to LED lights, clean heating and cooling, and requirements to renovate a certain proportion of buildings) can not only quickly become popular with NPL lenders and the investors that may fund them but also is badly needed given the percentage of existing stock which is already built as we move towards 2050. Moreover, ESG considerations could also be deployed or integrated into

a workout process. All of these plays do not come easily to a traditional NPL buyer that often just wants a return on capital as quickly as possible. We believe that this may be a scenario that would play out across Europe if loan sellers are faced with attractive bids from loan buyers driven by a different determination other than just buying for the lowest cost.

## INVESTOR PROFILES

There is a perception in the market that ESG investors are mostly focused on the more vanilla end of the capital markets—safe and uncontroversial assets. Interestingly, ESG is becoming important in the context of collateralized loan obligations, so is there a consistent ESG movement from uncontroversial assets to the securitization and NPL market?

The current NPL buyers often buy distressed loans at a discount (e.g., 30 pence in a pound) and offer the borrower debt relief (the debt gets rescheduled, with a new interest rate, and decreased principal) or enforce their security. As a result, their internal rate of return is high.

Is it possible to change the face of NPLs so that they are no longer considered a murky asset class for vulture funds, but something with a positive, social label that can attract new investors such as longer-term fixed-income investors such as sovereign wealth, insurance, or pension funds? We believe that this can be done.

## REINVENTING THE CURRENT APPROACH TO NPLS

Of course, some businesses might be structured in such a way that there is nothing that can be done to improve the business, and the purchasers of distressed loans will enforce security—given the scale of repurposing existing stock to green, it's inevitable that there will be stranded assets. However, we expect that the majority of distressed loans can be turned into performing loans if the ESG strategy is applied in the right way. There could also be money directed towards stranded assets in particular through the NPL market, and this may be a very interesting development yet to be executed in scale.

Arguably, there is a lot of social good in offering the borrower debt relief (effectively writing down debt). However, if the borrower works together with the buyer of NPLs and other third parties to turn the bad assets subject to security to assets with good ESG credentials, then there would be even more social good and positive PR generated as a result. This will be good for the loan sellers and the loan buyers—after all, rescue capital, venture capital, and distressed hedge funds could always benefit from some good PR!

Real estate assets—which in the current economic environment remain a very good hedge against inflation—could be turned into green buildings that

are energy efficient, with solar panels and other green features. The owners of NPLs could also focus on diversity and inclusion along with gender equality in the company and boardroom; the NPL borrowers might be encouraged to engage with the local community. Another issue is engagement with credit servicers and understanding their approach to ESG, which will come about following the NPL Directive.

### **WHAT ARE THE ADVANTAGES OF THIS NEW APPROACH TO DISTRESSED LOANS?**

The ultimate investors in the special opportunities funds and other investors often expect that the relevant investments are ESG compliant, and this trend will continue. So ESG focus would attract more capital to the NPL market and boost secondary markets.

We believe that the new ESG-conscious players might be prepared to accept lower returns on their investment than the current NPL players. This might mean that the sellers of NPLs would achieve a higher return and might encourage banks to sell more NPLs, so the NPL market might become more active.

ESG touch would help everyone—the NPL sellers, buyers, credit servicers, and NPL borrowers. For example, ESG touch would assist the financial sector within the EU with sustainability disclosure obligations. In addition, investments funds would be able to report back to their investors about ESG-compliant initiatives.

Given that NPLs and ESG is a new concept, there are some opportunities for creative investors to be one of the first players in this market and set up new funds with a new set of investment criteria focused on this segment of the market. What would be attractive for the ultimate investors is that their expected return on investment should be higher than more conservative ESG-compliant strategies. Higher interest rates combined with ESG-friendly initiatives would be very attractive in the current low-interest-rate environment.

### **A REGULATORY PUSH?**

Like all conversations surrounding ESG, there is typically a carrot and stick. In a stricter regulatory environment, the stick has wielded amazing results in Europe through regulatory frameworks such as the EU Sustainable Finance Disclosure Regulation (“SFDR”). The first provisions of the EU sustainability-related disclosures in the SFDR came into force in March 2021, as part of the EU Commission’s policy focus on sustainable finance and of the EU’s ambition to be climate-neutral by 2050. Broadly, the SFDR applies to a broad range of

financial market participants and aims to increase transparency and prevent 'greenwashing' by requiring enhanced disclosure of ESG products. Although these regulatory changes are being spearheaded in Europe, their repercussions will have a wider reach, as all financial market participants wanting to operate in the EU will have to comply.

Further regulatory movement in Europe comes from the EU taxonomy for sustainable activities—a classification system establishing a list of environmentally sustainable economic activities. The EU is also working towards an EU green bond standard. In the United States, regulatory movement comes from the Biden Administration and its recommitment to the Paris Agreement; the Green New Deal proposals in Congress; the SEC's request for public input from investors, registrants, and other market participants on climate change disclosure; and the Commodity Futures Trading Commission establishment of a new climate risk unit.

In the NPL world also there is movement that fits with existing European policy to lower the cost of NPL sales, attract more capital to the deleveraging process, and boost secondary markets in NPL disposals. The recent Directive (EU) 2021/2167 on Credit Servicers and Credit Purchasers relating to NPLs took effect on December 28, 2021. EU Member States are expected to implement the NPL Directive by December 29, 2023.

The main purpose of the NPL Directive is to ensure that an NPL borrower is not disadvantaged by the sale of an in-scope NPL, mostly through the mandatory engagement of credit servicers.

The NPL Directive also imposes rules designed to ensure a more transparent and well-functioning NPL secondary market by regulating the interactions between the banks and the NPL buyers. Whilst the NPL Directive does not apply to NPLs not originated by an EU-established bank or NPLs purchased by an EU-established bank, it does provide a useful framework which may be replicated across the globe.

The NPL Directive imposes various requirements on the credit servicers, including some requirements about the credit servicing agreement under which a credit servicer is acting. Any such agreement must include (1) a detailed description of the credit servicing activities that are to be undertaken, and (2) a clause requiring the fair and diligent treatment of the NPL borrowers (the ESG strategy described in this advisory would be helpful here).

We believe the NPL Directive could lead to banks more closely monitoring their default-prone NPL situations and come up with creative solutions to delever and manage these distressed assets or sell them to NPL buyers so they can also focus on financing solid assets—having these default-prone situations

off their balance sheet could also result in them providing vendor financing or co-investment financing to the new NPL lenders to integrate ESG policies.

### **ARE THERE ANY CHALLENGES TO FORMING A NEW FRONTIER OF NPLS AND ESG?**

All new initiatives present some challenges, and it is important to understand these challenges at the outset to be able to come up with robust action plans.

- New investors in this asset class would need to understand and comply with the regulatory framework.
- It is not clear that there will be a large wave of NPLs in the coming years—the uncertainty surrounding scale and volume may not be attractive to some.
- Would the borrower engage with the credit servicer in ESG initiatives without the threat of enforcement?
- How would you isolate the good parts of NPLs from the bad ones that may end up in an enforcement process?
- Would the NPL purchase that is going to factor in any ESG initiatives present an attractive investment for the traditional NPL investors (would the internal IRR criteria be met)?
- How would you obtain funding for ESG projects at the NPL borrower level designed to increase value and longevity of the borrower's business? Are there any local government or EU-backed schemes that could help with this?

### **HOW TO OVERCOME THESE CHALLENGES?**

ESG-related initiatives should attract investor capital, and this approach to NPLs and ESG is designed to complement the EU agenda on the sustainable finance landscape.

We recommend taking the following key steps:

- Be proactive in forming alliances with those institutions that have exposure to default-prone situations—a private NPL deleveraging may be more attractive than a public NPL sale.
- Those institutions that have exposure to default-prone situations should take a thorough inventory of their portfolio—know your risks (“KYR”) is something we cannot stress enough.
- EU NPL market participants, including U.S. and UK NPL investors,

should consider the information, disclosure, reporting, and conduct requirements imposed by the NPL Directive.

- Relationships with credit servicers will need to be established and relevant due diligence undertaken.
- Start with due diligence and then develop a sustainability strategy together with credit servicers and any other relevant third parties.
- Develop bespoke action plans at each NPL borrower to help them grow sustainably and to drive positive impact.

## CONCLUSION

It is clear that the call from investors for all lenders and borrowers to embrace ESG is just too loud to ignore—investors will increasingly only concentrate their money on the ESG-compliant and taxonomy-compliant sectors of the markets. Investor demand for ESG-related investments is not going away, and it is expected that this will only increase as demographics and public opinion on social and justice issues, the aftermath of the COVID-19 pandemic, and climate change continue to evolve, especially because there is more of a focus on climate change, climate-neutrality, and reduction to net zero emissions for all of our assets and investments than ever before. ESG leaders are now statistically shown to be better performing and generate better returns than ESG laggards.

The deleveraging loan market and the NPL market in particular are perfectly placed to embrace these developments, and we should expect more interaction between the NPL world and the ESG world. The future is indeed bright (if only renewable and decarbonized carbon-neutral bright!).