Covid-19 crisis: adverse consequences possible for NPL ABS in euro area periphery

The Covid-19 outbreak could result in unparalleled global economic disruption, as a large portion of the world population is forced into lockdown. While large uncertainties remain with respect to the length of the current situation and the shape of the subsequent recovery, a deep euro area recession is anticipated under all scenarios. In this fast-evolving context, there could be repercussions on securitisations of non-performing loans both in terms of timing and the amount of expected collections.

Scope publicly rates 25 securitisations backed by Italian non-performing loans plus one each in Spain and Portugal. In a recent study, we highlighted that these countries are among the most exposed to the synchronised current and upcoming healthcare capacity and economic shocks, as illustrated by their high dependence to GDP contributions from tourism and travel. They are also exposed because of the limited capacity of their health care systems, as captured by the number of medical staff and hospital beds per 1,000 people. Given the irregular flows stemming from non-performing assets, we consider recovery amounts and timing to be equally important. These principally depend on i) the economic environment; ii) the legal system and iii) property prices and marketability risks.

Early macro implications and public interventions

The uniqueness of the current crisis in terms of its origin, scope and speed makes it hard to generate precise forecasts at this stage. But it is clear that NPL transactions are exposed, as the shutdown of many non-essential activities in nearly all EU countries, particularly Italy and Spain, encompasses both the legal and real estate industries while having a direct economic impact. Italy's growth potential was already weak entering this crisis. The country was the first in Europe to be impacted heavily by the pandemic and is expected to have entered a technical recession in Q1, with deeply negative growth for the year. Spain, Portugal and a significant portion of the rest of the continent are also expected to have negative growth this year, despite numerous government support packages in recent weeks.

The effectiveness of fiscal stimulus hinges on four main factors:

(i) existing vulnerabilities, such as elevated levels of corporate and household indebtedness;

(ii) the fiscal position of each government and design of stimulus packages (direct spending vs tax cut vs income support etc.);

(iii) the speed and breadth of co-ordinated fiscal and monetary responses at the European level; and

(iv) the length of national epidemics and global restrictions.

Of all economies in the euro area periphery, private-sector indebtedness remains the most elevated in Portugal, where the corporate sector and households are among the mostly highly leveraged in Europe. However, as opposed to Italy, governments in Spain and Portugal have comparatively more fiscal space to respond to this extraordinary situation.

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Covid-19 Risks and Impact on the 2020 Global Outlook

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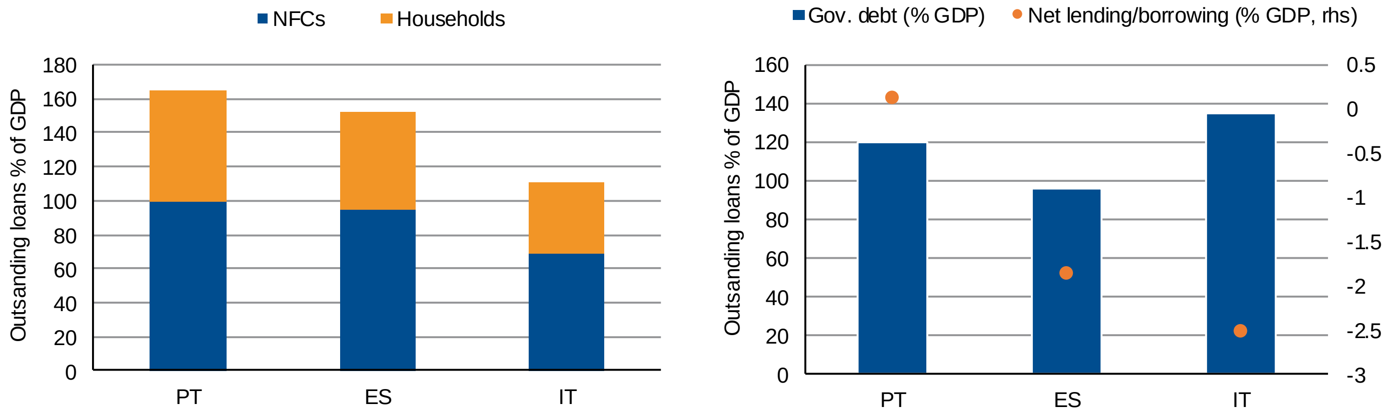
Figure 1: Private sector debt; Government debt to GDP and overall balance



Source: Haver, Eurostat, IMF, Scope Ratings

Unprecedented scope of European support packages

At the European level, both the European Commission and the ECB have been responsive in due measure, adopting extraordinary programmes such as the temporary framework for state aid and the EUR 750bn Pandemic Emergency Purchase Programme (PEPP), with the central bank further stressing that it remains ready to use other tools at its disposal. The ECB has already significantly increased the pace of its balance sheet expansion, deploying net purchases of EUR 17.4bn last week, which excludes any settlements made this week under the newly announced PEPP. These fiscal and monetary measures should mitigate, or at least delay, the expected turmoil for European businesses and households. However, the unprecedented scope of measures adopted globally also suggests that we are in uncharted territory.

Collection timing: a parallel shift envisaged

In the context of the current lockdown, the progress of NPL work-out strategies has slowed, or even stopped, in line with the rest of the economy. For instance, legal activity is impacted in all three countries, as courts are currently closed or only performing certain activities.

Courts suspension impacts the legal timing of transactions

In Italy, the government recently extended the suspension of civil and criminal court activities that started on 9 March for at least another three weeks, while some courts have already suspended auction proceedings until August. The freeze affects court appraisals, property inspections, auctions, final payments and release of properties i.e. court deadlines and cases at all judicial stages. This is happening in a context where the Italian legal system has already struggled to process the massive stock of collateral claims.

The backlog of legal cases is expected to be relatively high after the disruption period, which envisages a gradual recovery of activity. As part of the actual court suspensions (the length of which is still uncertain) and the resulting transition period necessary to return to normal activity, Scope expects a timing shift on all legal procedures, including cash in court, with a dynamic monitoring of market developments in order to assess the duration of delays as closely as possible. This also applies to other jurisdictions hit by the outbreak, including Portugal and Spain. Lengthy, volatile or unpredictable enforcement frameworks generally erode the amount of expected recovery proceeds.

All strategies to be impacted in terms of collection' timing

The parallel shift envisaged for legal timings could also apply to the rest of the expected collections – including time-to-sale assumptions in the case of properties that have already been repossessed – as elements such as the impossibility to perform property visits and the lack of investor appetite make it hard to envision actual sales.

With the judicial processes unlikely to progress, special servicers might be encouraged to rely more on extra-judicial processes. However, we expect their ability to realise these types of collections to be limited in the current context, as debtors, whether individuals or corporates, are not incentivised to settle in such macro-economic uncertainty, especially as many businesses fear massive contraction of their operational cash flow.

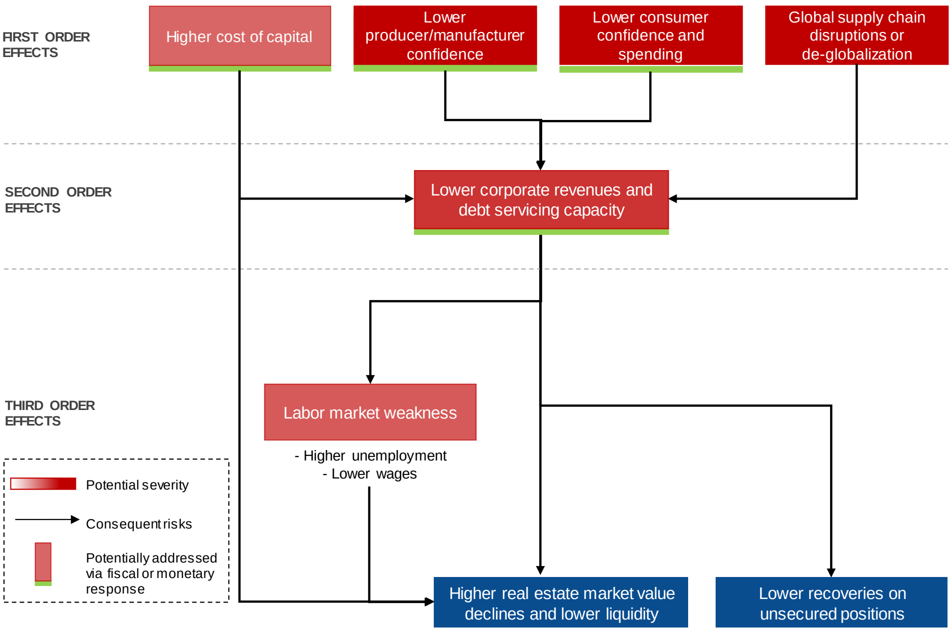
As highlighted in a recent study measuring the performance of Italian transactions to date, half of outstanding transactions are already behind on expected timing, versus initial business plans. This number could go up over upcoming quarters, impairing further the performance of the related transactions.

Real estate value: short-term disruption with long-term effects?

Scope's market value decline assumptions capture a certain level of stress to the prices

Scope's fundamental approach with regard to market value risk for secured assets already captures, to a certain extent, potential price declines by means of rating conditional stresses. Our base case market-value decline assumptions reflect expectations for property prices across jurisdictions, over the short-term, as opposed to their current levels, while the AAA_{SF} rating conditional stress captures a larger degree of the historical volatility in what would be our view of a highly distressed market environment. At this stage, we expect the ongoing events to negatively impact real estate markets in the short term. Specific mid- to long-term developments are difficult to estimate at this stage, considering the absence of market activity and uncertainties around the macro-economic environment, which is highly correlated with property prices. As shown in Figure 2, consumer and producer confidence, cost of capital, economic growth in general, as well as labour market conditions, are key drivers of the real estate market and are under threat of severe deterioration.

Figure 2: Fundamental drivers of the real estate market value (Scope's base case)



Source: Scope Ratings

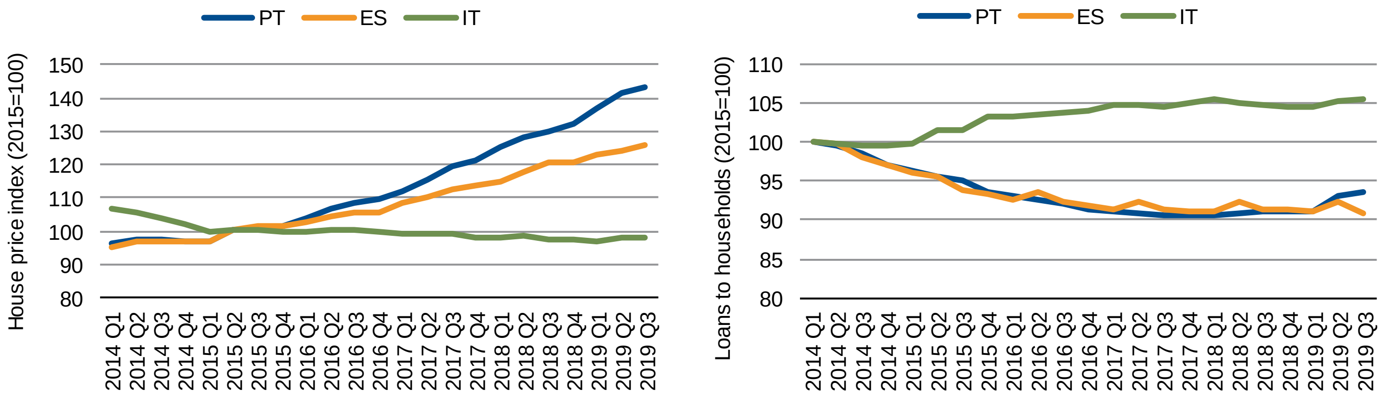
Portugal has faced the largest price increase since 2014

Euro area periphery countries are at different stages of their real estate cycles. For instance, Italy's property prices have not appreciated much since the trough of 2013, while early signs of overheating were already visible in Iberia before the Covid-19 pandemic hit European shores. This is most evident in Portugal where, despite the economic growth momentum and the reduction of unemployment, the recent boom in house prices has not coincided with growth in domestic credit.

The latter was used for financing only 40% of transactions as of Q1 2019[1], a much lower level than before the euro sovereign crisis (c.65% in 2011).

Meanwhile, the purchase of residential real estate by non-residents has continuously driven demand and pushed prices up. The value of real estate purchased by non-residents increased by 22% in 2019, as opposed to 5.6% for residents. Such a sizable driver could be at risk following both the lockdown, and the desire by Portuguese authorities to contain 'golden visa' programmes, which are elements eventually threatening the residential market in the short term.

Figure 3: House prices and credit to households



Source: Haver, ECB, Scope Ratings

Direct impact on some segments of commercial real estate

The commercial property end should be affected as well. In the near future, sub sectors the most exposed to short-term leases and social distancing impacts will suffer the most, namely development, high-street retail, hotels, shopping malls. Logistics and offices are likely to be more resilient despite leasing slowing down. While we currently face a lack of transactions, downward pressure on prices should materialize soon, as all sub-asset classes will likely be exposed to rent payment deferrals, tenant defaults and increasing vacancy. Liquidity risks will arise due to due diligences being on hold following lockdowns and very few issuances expected on capital markets. In the context of NPL portfolios, we do not expect an immediate impact on appraised values given the typical time lag observed before real estate prices reflect the macro-economic environment.

Challenging context weighing on collection amounts

Willingness of unsecured borrowers to settle could slow down

As we start observing moratoriums on debt payments for various types of corporate and SME debt, potential spill-over effects could arise from the unwillingness of defaulted borrowers to seek amicable agreements, or to honour recently negotiated payment plans. In some jurisdictions such as Italy, payment holidays are also applicable to individuals in the context of mortgage payments on their principal residences[2], while all households in the "red area" are allowed to request suspension of full instalments or principal through to the end of the emergency. Some measures will be applied for the next six months, indicating that the adverse impact on servicers' collection abilities could last longer than the shutdown.

Large support packages for corporates and households…

Debt moratoriums are part of larger fiscal plans in collaboration with banks, providing cash flow relief to households and corporates, as well as State guarantees.

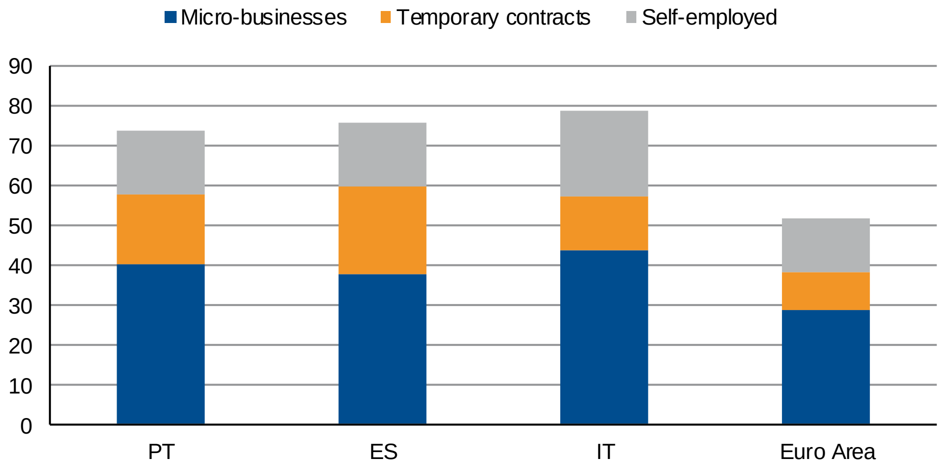
[1] Financial Stability Report – Banco de Portugal (December 2019)
[2] Limited to freelancers suffering a drop of over one third of income in the first quarter; for now.

In Italy, the EUR 25bn package includes suspensions in tax payments and pension contribution for all companies, and direct subsidy of EUR 600 a month for freelancers. Spain (EUR 17bn) and Portugal (EUR 9bn) have adopted similar measures such as the interruption of the duty to apply for insolvency proceedings within a period of two months.

To ease the upcoming impairment of debt servicing capacities

The historical performance for most NPL servicers covers collections realised in relatively benign market conditions. Their ability to collect in a tight environment remains to be seen. For situations where servicers expect to reach amicable agreements, we expect borrowers' cash flow generation to become under pressure. In fact, peripheral euro area countries have a relatively high share of micro-businesses (which usually have lower liquidity compared to larger corporates) and a large number of individuals either self-employed or employed on temporary contracts who have a higher risk of losing income, leaving them financially more exposed in times of distress.

Figure 4: Share of temporary contracts[3] , self-employed[4] and micro businesses[5] in peripheral economies (%)



Source: Eurostat, Scope Ratings

NPL securitisations: Increase of liquidity and counterparty risks

Liquidity sources of NPL transactions to be put to the test

Suspension of court proceedings and a sharp drop in economic activity could lead to an increase in the liquidity risk of NPL securitisations. A missed payment of interest on senior notes triggers, for most non-GACS transactions, an enforcement event, under which the servicer is required to liquidate the portfolio and accelerate the repayment of senior notes.

In the case of Italian GACS transactions, missed interest payments on senior notes lead to enforcement of the guarantee, which, however, is only paid-out after the legal maturity date of the senior notes. NPL securitisations rated by Scope generally feature a minimum of 12 months of liquidity coverage, partially mitigating liquidity risk. However, some transactions may still suffer due to below average levels of coverage. In addition, given the uncertainty around the length of the current crisis, the robustness of such reserves may be put to a rigorous test.

[3] Measured as % of total employment for 15-64 years old, as of Q3 2019
[4] Self-employed, 15 years old and older; as of 2018
[5] Measured as businesses from 0 to 9 employees as % of total business economy; except financial and insurance activities, as of 2017

Scope monitors counterparty risk

Counterparty risk could also increase due to higher costs of capital and the liquidity crunch faced by key counterparties on NPL transactions, such as special servicers. A significant drop in gross collections could also deteriorate reduce the financial strength of servicers, especially those whose revenue streams rely primarily on variable performance fees. Such effects may be further aggravated by partial deferrals of fees due to structural covenants ("under-performance triggers") based on performance[6].

We review servicers' financials and business continuity plans as part of our counterparty risk analysis, both in the context of the initial rating process and on an ongoing basis during the life of transactions. Back-up servicing agreements mitigate potential servicer disruption events and associated counterparty risk.

[6] Italian NPL ABS Performance – Scope Ratings (Feb 2020)

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