RED SEA SPV S.r.l.

Non-Performing Loans (NPL)

Ratings

Tranche	Rating	Size (EURm)	Thickness (%)	% of GBV[1]	Coupon	Final maturity
Class A	BBB_{SF}	1,656.5	89.0	32.5	6m-Euribor + 0.6%	Oct 2038
Class B	NR	152,9	8.2	3.0	6m-Euribor + 6.0%	Oct 2038
Class J	NR	51.0	2.7	1.0	variable	Oct 2038

Scope's Structured Finance Ratings constitute an opinion about the relative credit risks and reflect the expected loss associated with the payments contractually promised by an instrument on a particular payment date or by its legal maturity. See Scope's website for the SF Rating Definitions.

[1] Gross book value (GBV) of the securitised portfolio at closing (EUR 5,096m)

Transaction details

Purpose	Risk transfer
Issuer	Red Sea SPV S.r.l.
Originators	Banco BPM S.p.A and Banca Popolare di Milano S.p.A
Servicer	Prelios Credit Servicing S.p.A.
Portfolio cut-off date	30 September 2017
Issuance date	15 June 2018
Payment frequency	Semi-annual (April and October)
Arrangers	Banca Akros, Deutsche Bank, Mediobanca – Banca di Credito Finanziario

The transaction is a cash securitisation of a static Italian NPL portfolio of EUR 5,097m by gross book value. The portfolio comprises first lien secured (70.6%), unsecured (28.4%) and junior lien secured (1.0%) loans. The loans were extended to companies (71.6%) and individuals (28.4%) and were originated by Banco BPM and Banca Popolare di Milano, both part of the Banco BPM Group. Secured loans are backed by residential (54.8% of property valuations) and non-residential (45.2%) properties which are highly concentrated in the metropolitan area of Milan (10.3%) and other northern Italian regions (57.5%). The issuer acquired the portfolio on 1 June 2018, but is entitled to all portfolio collections received since 30 September 2017 (the portfolio cut-off date). Asset information reflects aggregation by loans.

The structure comprises three classes of notes with fully sequential principal amortisation: senior class A, mezzanine class B, and junior class J. The class B interest margin ranks senior to class A principal at closing but will be deferred if special servicer performance triggers are breached, while the index component always ranks junior to class A principal. Class J principal and interest are subordinated to the repayment of the senior and mezzanine notes.

Rating rationale (summary)

The ratings are mainly driven by recovery amounts and timing from the NPL portfolio, which was acquired by the issuer at a 63.5% discount relative to the portfolio's gross book value. Scope's recovery and timing assumptions incorporate its economic outlook for Italy, as well as a positive assessment of the special servicer's capabilities. The ratings are supported by the structural protection provided to the notes, the absence of equity leakage provisions, liquidity protection, and interest rate hedging agreements.

The ratings also address exposures to the key transaction counterparties: Prelios Credit Servicing, special and master servicer; Securitisation Servicers, noteholders' representative, calculation agent, monitoring agent and back-up master servicer; The Bank of New York Mellon, account bank, paying agent and cash manager; Banco BPM, interim collections account bank; and Mediobanca-Banca di Credito Finanziario and Banco Santander, as interest rate cap providers. Scope factored counterparty replacement triggers implemented in the transaction into its analysis, and relied on

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Related Research

General Structured Finance Rating Methodology, August 2017

Methodology for Counterparty Risk in Structured Finance, August 2017

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Scope's rating on Banco Santander and publicly available ratings on The Bank of New York Mellon, Banco BPM and Mediobanca.

Scope performed a specific analysis for secured and unsecured exposures. For secured exposures, collection assumptions were mostly based on up-to-date property appraisal values which were stressed to account for liquidity and market value risks, while recovery timing assumptions were derived using line-by-line asset information detailing the type of legal proceeding, the court issuing the proceeding, and the stage of the proceeding at the cut-off date. For unsecured exposures, Scope used historical, line-by-line recovery data on defaulted loans between 2000 and 2017 and calibrated recoveries, considering unsecured borrowers to be classified as defaulted for an average of 3.5 years as of closing.

Rating drivers and mitigants

Positive rating drivers

Loan types. The quality of the portfolio is high compared to peer transactions rated by Scope because it includes a greater relative share of first lien secured loans, which offer better recovery rates on average, and a large proportion of residential collateral, thus reducing concentration risk.

Location. The portfolio is concentrated in the metropolitan area of Milan and other northern Italian regions. These regions benefit from the most dynamic economic conditions in the country and, in general, the most efficient tribunals.

Granularity. The concentration in the portfolio is low compared to peer transactions rated by Scope. The 10 and 100 largest borrower exposures account for 1.8% and 9.1% of gross book value, respectively.

Portfolio servicing. The performance fee structure reasonably aligns incentives between the servicers and the investors. In the event of a servicer disruption, the monitoring agent will assist the issuer in finding a suitable replacement.

Liquidity protection. A cash reserve representing 4% of the outstanding class A and class B notes' balance protects the liquidity of senior noteholders, covering senior expenses and interest on class A notes for about four payment dates as of closing.

Real estate recovery. Scope expects a gradual recovery of Italian real estate prices, despite weak medium-term economic growth potential, driven by moderate private sector indebtedness and improving property affordability. Scope applied a moderate nominal property price decline stress of 6.9% for the analysis of the rated notes, reflecting our view of limited downside risk.

Negative rating drivers and mitigants

Collateral liquidity. Fire-sale discount assumptions constitute the primary source of portfolio performance stresses. Scope applied an average fire-sale discount of 29.1% to security valuations for the analysis of the rated notes, reflecting significant liquidity or marketability risks.

Seasoned unsecured portfolio. The weighted average time since loan default is approximately 3.5 years for the unsecured portion. Most unsecured recoveries are realised in the first years after a default according to historical data.

Concentrated portfolio. NPL collateral appraisals are more uncertain than standard appraisals because repossessed assets are more likely to deteriorate in value.

Class B margin seniority. The margin component of class B interest ranks senior to class A principal at closing and will only be deferred if the special servicer does not meet at least 70% of the business plan collections schedule. The level of the trigger is low relative to peer transactions rated by Scope.

Interest rate risk partially unhedged. The interest rate cap only party mitigates the risk of increased liabilities on the notes in the event of a rise in Euribor levels, because a) the swap notional schedule falls below Scope's expected class A notes amortisation schedule, and b) the strike schedule is increasing from 0.5% as of closing to 2% from May 2026.

Upside rating-change drivers

Legal costs. A decrease in legal expenses could positively affect the ratings. Scope factored in the legal expenses for collections detailed in the servicer business plan, which average about 11% of gross collections and are relatively high compared with peer transactions.

Servicer recovery timing outperformance. Consistent servicer outperformance in terms of recovery timing could positively impact the ratings. Portfolio collections will be completed over a weighted average period of about 4.5 years, according to the servicers' business plan. This is about 2 years faster than the recovery timing vector applied for the analysis of the rated notes. Scope expects recent legal reforms to have a positive impact on court performance and has applied a limited stress to recovery timing assumptions.

Downside rating-change drivers

Fragile economic growth. The trajectory of Italy's public debt is a cause for concern given weak medium-term growth potential of 0.75% alongside the new government's plans to roll back reform, raise spending and cut taxes.

Swap notional mismatch. Delayed recoveries beyond Scope's stressed recovery timing vector would increase the mismatch between the transaction's interest rate cap notional and the outstanding principal of the rated notes.

Collateral appraisal values. An upward bias of appraisal values beyond the liquidity stresses captured by Scope could result in a rating downgrade. NPL collateral appraisals are more uncertain than standard appraisals because repossessed assets are more likely to deteriorate in value.

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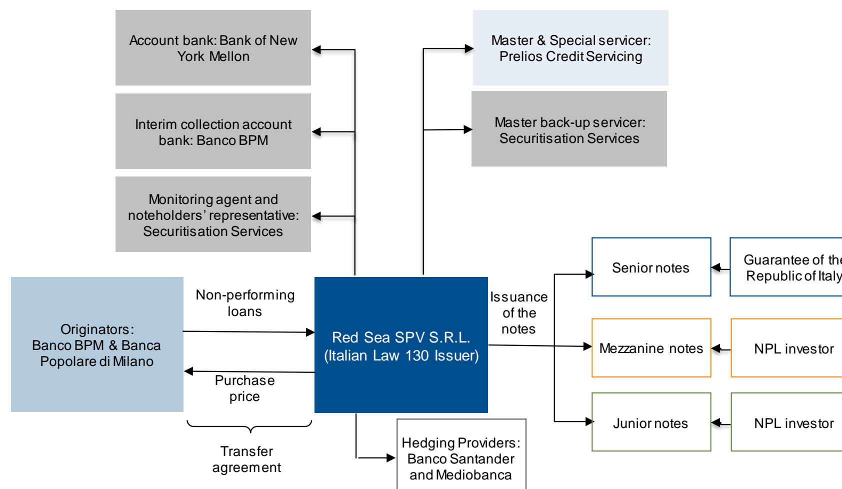
1. Transaction summary

The transaction structure comprises three tranches of sequential principal amortising notes, an amortising liquidity reserve equal to 4% of the outstanding class A and class B notes, and an interest rate cap agreement.

Figure 1: Transaction diagram:



Sources: Transaction documents and Scope Ratings.

Figure 2 shows the main characteristics of the preliminary portfolio analysed by Scope:

Figure 2: Key portfolio stratifications[1]

	All	Secured	Unsecured
Number of loans	33,585	13,602	19,983
Number of borrowers	12,651		
Gross book value (EUR m)	5,113	3,610	1,503
% of gross book value (GBV)	100%	70.6%	29.4%
Weighted average seasoning (years)	3.8	3.9	3.5
Sum of collateral appraisal values (EUR m)		4,495	
Borrower type			
Corporate	71.6%	62.5%	94.6%
Individual	28.4%	37.5%	5.4%
Primary legal procedure			
Bankrupt borrower	37.7%	28.9%	59.8%
Non-bankrupt borrower	50.6%	58.0%	32.2%
Not started or unknown	11.7%	13.1%	8.1%
Stage of procedure (secured loans)			
Initial		58.7%	
Court-appointed valuation (CTU)		9.9%	
Auction		22.0%	
Distribution		9.4%	
Collateral location (% of appraisal values)			
North		67.8%	
Centre		20.7%	
South and islands		11.4%	
Borrower concentration (% of GBV)			
Top 10	1.8%		
Top 100	9.1%		
Property type (% appraisal values)			
Residential		54.8%	
Non-residential		45.2%	

Sources: Transaction datatape; calculations and/or assumptions by Scope Ratings

[1] The portfolio stratifications are provided for the preliminary portfolio. The closing portfolio has a slightly lower balance than the preliminary portfolio (EUR 5,097m instead of EUR 5,113m) due to the exclusion of a few loans which did not meet the eligibility criteria, but this does not imply any material changes to the portfolio stratifications.

2. Macroeconomic environment

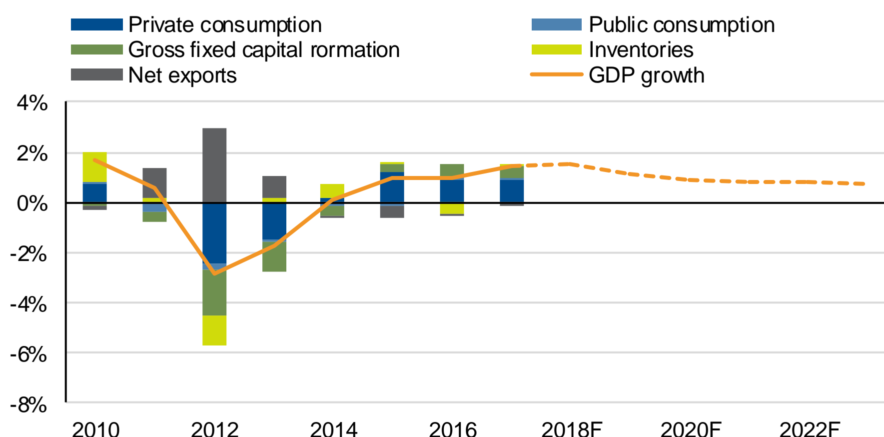
Gradual property price recovery despite economic challenges

Scope's portfolio recovery amount and timing expectations reflect Scope's expectation of a gradual recovery of Italian real estate prices and progress in delivering structural reforms, notwithstanding weak medium term economic growth potential. The cyclical recovery from current trough levels will be driven by moderate private sector indebtedness and an improving property affordability trends.

Large and diversified economy

Scope's sovereign rating on Italy (A-/Negative) is underpinned by a large and diversified economy and a cyclical rebound against the backdrop of long-term economic challenges. The negative outlook reflects that the trajectory of Italy's public debt is a cause for concern given weak medium-term growth potential of 0.75% alongside the new government's plans to roll back reform, raise spending and cut taxes.

Figure 3: Percentage-point contribution to real GDP growth



Sources: IMF, national statistical accounts, calculations by Scope Ratings

Moderate private debt levels

The IMF, in its April 2018 World Economic Outlook (WEO), revised Italy's 2018 growth forecast to 1.5% from 1.1% and raised its 2019 expectations to 1.1% from 0.9%. Italy's manufacturing sector – the second largest in the euro area after Germany's – has helped to generate current-account surpluses since 2013 (2.8% of GDP in 2017). Unlike many advanced economies, Italy did not experience a credit-driven boom-bust cycle before the 2008 crisis. Domestic non-financial private debt stands at a comparatively moderate 156% of GDP as of Q3 2017, comparing favourably against euro area peers.

Weak long-term growth prospects

While the cyclical rebound exceeded expectations, long-term growth prospects remain weak. The IMF's medium-term forecast[2] remained at 0.8% in the April 2018 WEO. Italy's production capacity fell in the aftermath of the global financial crisis. As of February 2018, industrial production volumes stood at 81% of early 2008 levels. This comes in contrast to the full recovery in Germany's industrial production post-crisis.

The drop in industrial production capacity reflects the vulnerabilities within Italy's production infrastructure. More than 90% of manufacturing output is generated by micro-firms concentrated in industrial districts. While these firms are competitive in their global niche markets (luxury clothing, household goods, food processing, mechanical products, and motor vehicles), they remain susceptible to market shocks. Their financing capacities are limited and were hit hard during the euro crisis.

Unemployment continues to gradually drift downward from its 2014 peak (13% in November) and was 10.9% as of February 2018. Wage growth has picked up 1.0% YoY as of March 2018. However, inflation remains tepid at only 0.5% YoY in April 2018.

[2] Referring to the IMF's April 2018 WEO's forecast for 2023 growth.

Political and banking system challenges

At the same time, political uncertainties following the March 2018 general elections, as well as ongoing challenges in the banking sector, may weigh on the economic rebound. Italian banks' lending to residents rose 1.9% YoY in February 2018, a modest growth after the previous years of contraction.

3. Portfolio analysis

Rating-conditional recovery assumptions

Figures 4 compares Scope's lifetime gross collections and recovery timing assumptions for the entire portfolio against those of the servicer's business plan. Scope has applied rating-conditional recovery rates (i.e. lower recoveries as the instrument's target rating increases). These assumptions result from the blending of secured and unsecured recovery expectations. Scope has applied different analytical frameworks to the secured and unsecured segments to derive recoveries.

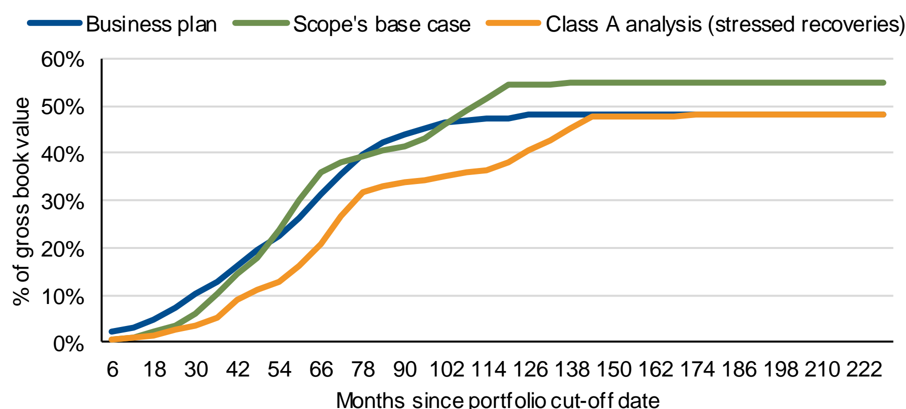
Scope expects a gross recovery rate of 55.1% over a weighted average life of 5.5 years, under a base case scenario. By portfolio segment, Scope expects gross recovery rates of 71.9% and 14.7% for the secured and unsecured portfolios, respectively.

For the analysis of the class A notes, Scope applied a 12.8% recovery rate haircut and a recovery lag stress of almost 1 year, resulting in a 48.0% gross recovery rate over a weighted average life of 6.4 years. By portfolio segment, Scope assumed gross recovery rates of 62.8% and 12.3% for the secured and unsecured portfolios, respectively.

Scope's assumptions reflect significant recovery timing stresses

The set of assumptions applied for the analysis of the rated notes reflect a significant stress on cash-flow timing, driven among other factors by a slower ramp-up period and tribunal timing stresses. Scope has not applied recovery amount stresses significantly below the business plan expectations, mainly due to its credit-positive view on the real estate cyclical recovery.

Figure 4: Business plan total expected recoveries vs Scope's assumptions



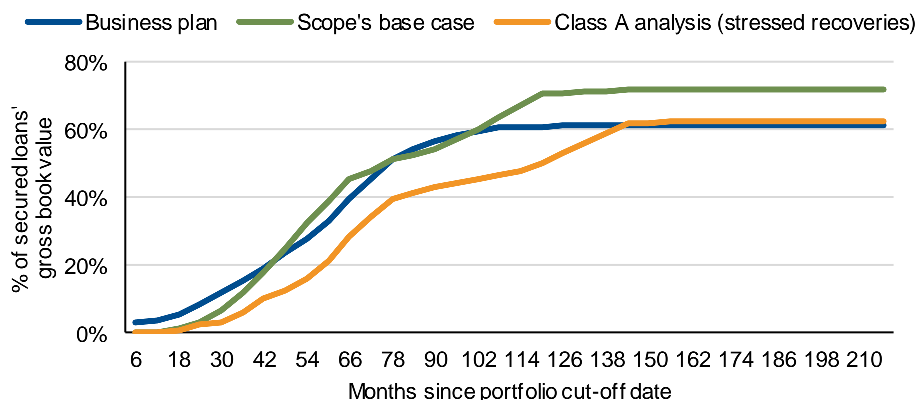
Sources: Special servicer's business plan and Scope Ratings

3.1. Analysis of secured portfolio segment

Valuation haircuts mainly address forward-looking market value and liquidity risks

Figures 5 shows Scope's lifetime gross-collections vectors for the secured portfolio segment compared to those in the servicer business plan. Scope's analytical approach consists mainly of estimating the security's current value based on property appraisals and then applying security-value haircuts to capture forward-looking market value and liquidity risks. Recovery timing assumptions are mainly determined by the efficiency of the assigned court (based on historical data on the length of the proceedings), by the type of legal proceeding and by the stage of the proceeding. Scope's analysis also captures concentration risk, the servicer's business plan, and available workout options.

Figure 5: Business plan secured loans expected recoveries vs Scope's assumptions



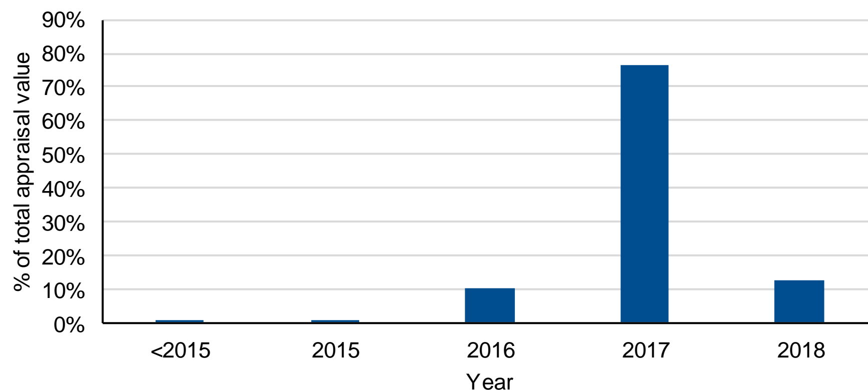
Sources: Special servicer's business plan and Scope Ratings

3.1.1. Appraisal analysis

Positive credit given to the quality of property appraisals

Scope has relied on line-by-line property market value appraisals conducted by Prelios Valuation Services, an independent operating company of the Prelios Group, and other duly authorised and qualified third parties. The vast majority of the valuations are recent, i.e. conducted between 2016 and 2018. Scope has indexed seasoned valuations using a variety of regional price indices. Indexation has a marginal impact on this NPL portfolio because property prices have remained fairly flat since 2015.

Figure 6: Collateral valuation dates



Source: Transaction datatape

Scope views positively that most of the portfolio's collateral appraisals are either a drive-by or full valuations (74.0%). A smaller portion is composed of desktop (14.5%) and CTU (11.5%) valuations, to which Scope applied 5% and 10% rating-conditional haircuts respectively, reflecting the agency's view of their lower levels of quality and accuracy due to the simplified procedures.

Figure 7: Portfolio appraisal types and Scope's transaction-specific valuation haircut assumptions

Valuation type	% of collateral value	Valuation haircut (%)
Full	10.7	0
Drive-by	63.3	0
Desktop	14.5	5
CTU	11.5	10

Sources: Transaction datatape; calculations and/or assumptions by Scope Ratings

3.1.2. Property market value assumptions

Moderate market downturn risk

Figure 8 details Scope's base case assumptions on property price changes over the transaction's lifetime, and the rating-conditional stresses applied for the analysis of the class A notes. These assumptions are transaction and region-specific and based on an analysis of historical property price volatility and on fundamental metrics relating to property affordability, property profitability, private-sector indebtedness, the credit cycle, population dynamics and long-term macroeconomic performance.

Figure 8: Collateral location and Scope's transaction-specific price change assumptions

	North						Centre			South			Islands	
Region	Milan	Turin	Geneva	Bologna	Venice	Others	Rome	Florence	Others	Naples	Bari	Others	Metropol-itan cities	Rest of provinces
Base case	+7.0													
Class A analysis	-4.6	-4.6	-5.4	-4.6	-8.0	-6.7	-8.9	-6.7	-6.7	-8.9	-7.6	-11.0	-9.7	-11.0
Portfolio distribution (%)	10.3	2.1	1.5	1.4	1.4	51.1	5.1	0.7	14.9	2.1	0.4	3.7	3.8	1.4

3.1.3. Collateral liquidity risk

High NPL collateral liquidity and obsolescence risk

At times of severe economic stress during which NPLs typically accumulate, tight financing conditions and/or restricted access to capital markets drive liquidity risk. During recovery and expansionary phases of the cycle, liquidity risk may persist, mainly due to information asymmetries and collateral obsolescence, the latter primarily affecting industrial properties.

Asset illiquidity risk is captured through additional fire-sale haircuts applied to collateral valuations. Figure 9 below shows the rating-conditional haircuts applied for the analysis of the class A notes. These assumptions are based on historical distressed property sales data provided by the servicers and reflect Scope's view that non-residential properties tend to be less liquid, resulting in higher distressed-sale discounts.

Figure 9: Scope's transaction-specific fire-sale discount assumptions

Collateral type	% of collateral value	Fire-sale haircut (%)
Residential	54.8	25.0
Non-residential	45.2	30.0

3.1.4. Concentration haircuts

Very limited borrower concentration risk

Scope has addressed borrower concentration risk by applying an 10.0% rating-conditional recovery haircut on the 10 largest borrowers for the analysis of the class A notes. This assumption has a minimal impact, given that the largest 10 borrowers account for only 1.8% of the portfolio's gross book value.

3.1.5. Residual claims after security enforcement

Scope addresses potential residual claims after security enforcement

A secured creditor may initiate enforcement actions against a debtor despite the closure of an enforcement action concerning the mortgaged property. Secured creditors generally rank equally with unsecured creditors for amounts that have not been satisfied with the security's enforcement. The creditor's right to recover its claim, whether secured or unsecured, arises with an enforceable title (i.e. a judgment such as an agreement signed before a public notary).

No credit to residual claims from corporate borrowers

For corporate loans, Scope has given no credit to potential further recoveries on residual claims after the security is enforced. This is due to three practical limitations: firstly, unsecured recoveries tend to be binary with a high probability of zero recoveries and a

low probability of 100% recoveries. This implies that under the scenario that secured creditors are not fully satisfied after the enforcement of the security, expected recoveries for unsecured creditors will be close to zero[3]. Secondly, special servicers are generally less incentivised to pursue alternative enforcement actions, given that foreclosure proceedings are more cost-efficient. Lastly, in a bankruptcy proceeding the receiver will decide to close the proceedings after a prudential amount of time, setting a practical limitation for any potential recovery upside.

Partial credit to residual claims from individuals

Scope has given credit to residual claims on 80% of loans to individuals. This is because if the borrower is an individual, the elapsed time after a default might have a positive impact. An individual may, for example, find new sources of income over time and become solvent again.

3.1.6. Tribunal efficiency

Scope applied line-by-line time-to-recovery assumptions considering the court in charge of the proceedings, the type of legal proceeding (i.e. bankruptcy or non-bankruptcy), and the current stage of the proceeding.

Northern regions tend to have more efficient tribunals

The total length of the recovery processes is mainly determined by the efficiency of the assigned court and by the type of legal proceeding. To reflect this, Scope has grouped Italian courts into seven categories, based on public data on the average length of bankruptcy and foreclosure proceedings between 2015 and 2017, as shown in Figure 10 below. Most courts are concentrated within groups 2 to 4 which are reasonably distributed across all Italian regions. Nevertheless, northern regions tend to have more efficient tribunals on average (see Figures 14 and 15 for transaction-specific details).

Figure 10: Total length of the recovery process by court group in years (Scope's assumptions)

Court group	Bankrupcy proceedings	Non-bankruptcy proceedings	% of courts
1	4.0	2.0	5%
2	6.0	3.0	32%
3	8.0	4.0	26%
4	10.0	5.0	23%
5	12.0	6.0	7%
6	14.0	7.0	4%
7	18.0	9.0	4%

3.2. Analysis of unsecured portfolio segment

Unsecured portfolio analysis is based on statistical data

Figure 11 shows Scope's lifetime gross-collections vectors for the unsecured portfolio segment compared to those of the servicer business plan. The peak observed in the servicer business plan collection vector on month 126 is explained by residual collection assumptions at the end of the servicer business plan collection period.

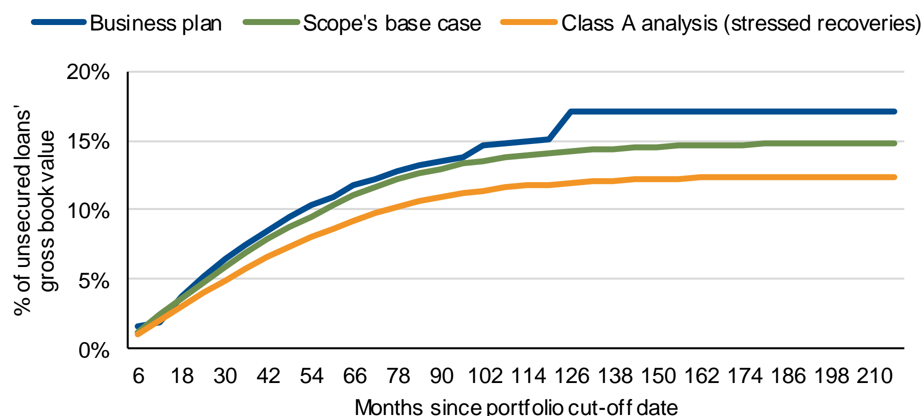
Scope's slightly more conservative base case recovery amount and timing assumptions are based on recovery vintage data on a representative sample of loans as provided by Banco BPM, and on peer transactions' performance data. For the analysis of the class A notes, Scope has applied a rating-conditional recovery rate haircut of 16%.

Scope's assumptions for unsecured exposures consider the nature of the recovery procedure; bankruptcy proceedings are generally slower and typically result in lower

[3] Conversely, in the unlikely scenario that secured creditors are fully satisfied after the enforcement of the security, expected recoveries for unsecured creditors could be close to 100%.

recoveries than non-bankruptcy proceedings. The assumptions are calibrated to reflect that unsecured borrowers in the portfolio are classified as having defaulted for an average of 3.5 years as of the cut-off date.

Figure 11: Business plan unsecured loans expected recoveries vs Scope's assumptions



Sources: Special servicer's business plan and Scope Ratings

4. Portfolio characteristics

Below we provide further detail on key portfolio characteristics as of 30 September 2017. Percentage figures refer to gross book value, unless otherwise stated.

4.1. Eligible loans

Customary eligibility criteria

Scope is satisfied with the extent of the representations and warranties provided by the originators regarding the receivables, which is generally in line with those of peer transactions rated by Scope. The most relevant criteria with which the receivables must comply in order to be included in the securitisation portfolio are the following:

- All receivables are valid, existing and enforceable;
- The information provided by the originators in the transaction datatape (including gross book value, collateral value and mortgage lien, among others) is correct complete and accurate;
- All loans are denominated in euros;
- All loan agreements are governed by Italian law;
- All receivables are validly transferable without any limitations;
- All receivables are free from any encumbrances;
- There are no claims that may be set-off against any of the receivables;
- All debtors are reported by the originator as defaulted (in sofferenza) to the Italian Credit Bureau (Centrale Rischi) of the Bank of Italy as of the portfolio cutoff date (30 September 2017);
- All bankruptcy proceedings relating to bankrupt debtors were not closed and ongoing as of the portfolio cut-off date;
- All real estate assets charged with voluntary mortgages are insured against risk of fire, explosion or lightning;
- All voluntary mortgages are backed by real estate assets located in Italy;
- There are no mortgages that will expire within 60 calendar days after the transfer date (1 July 2018).

4.2. Detailed stratifications

4.2.1. Borrower type

Relatively high share of individual borrowers is credit-positive

Corporates and individuals represent 71.6% and 28.4% of the pool respectively. The share of secured individual borrowers (26.8%) is relatively high compared with peer NPL transactions rated by Scope. This is a positive feature, mainly because Scope gives partial credit to residual claims from individuals after security enforcement, as discussed in the previous section.

High share of first-lien secured loans is credit-positive

The relatively high amount of first-lien secured loans (70.6%) is positive. Scope has assumed that recovery proceeds from junior-lien secured loans (1.0%) will be the same as for unsecured loans.

Figure 12: Borrower type

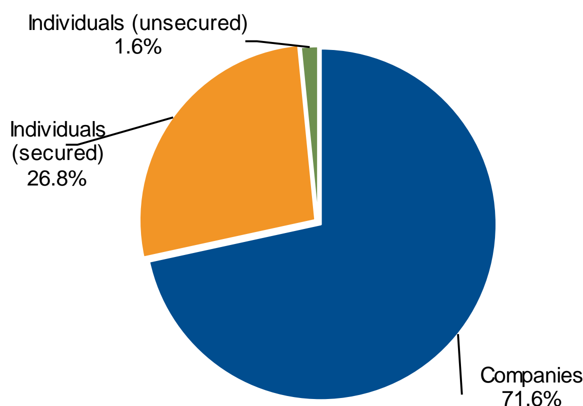
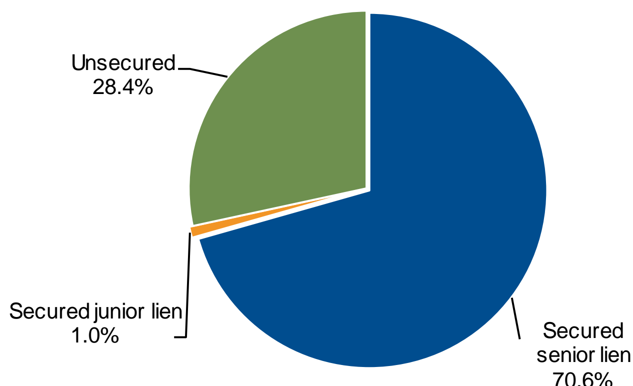


Figure 13: Loan type



Sources: Transaction datatape: calculations by Scope Ratings

4.2.2. Geographical distribution

Geographical concentration in the north is credit-positive

The location of the portfolio should positively affect the level and timing of recovery proceeds, because the collateral and court proceedings are concentrated in northern Italian regions, particularly in the metropolitan area of Milan. These regions benefit from the most dynamic economic conditions in Italy, typically reflected by more resilient property values (see Figure 8) and, in general, the most efficient tribunals. The latter is reflected in the transaction's court group distribution, which is skewed towards more efficient court groups relative to the national average (compare Figure 10 with Figure 15).

Figure 14: Collateral location

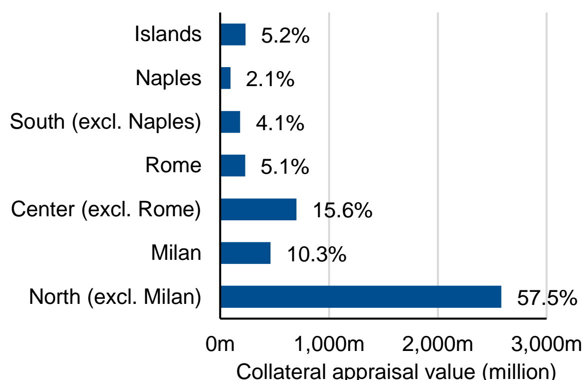
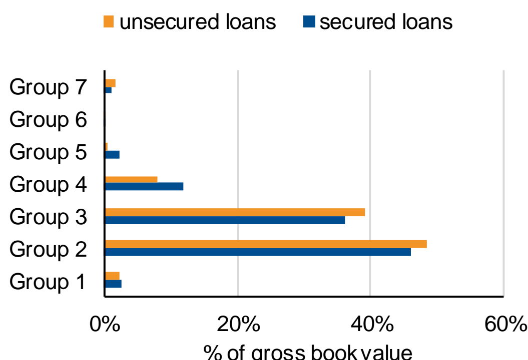


Figure 15: Court group distribution of loans for which proceedings have started



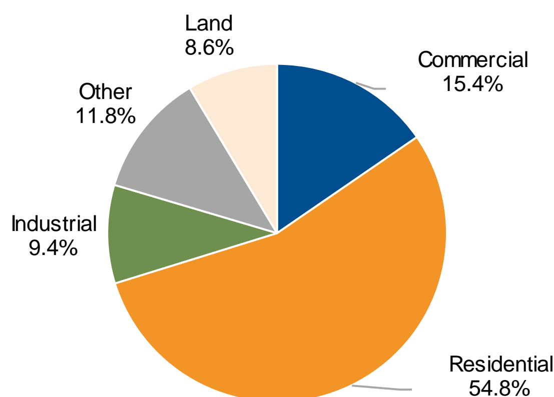
Sources: Transaction's datatape; calculations by Scope Ratings

Lower liquidity stresses applied to residential properties

4.2.3. Collateral type

The collateral is composed of residential (54.8%), commercial (15.4%), industrial (9.4%) and other non-residential assets (20.4%) (mainly buildable land, agricultural land or diverse types of asset under construction). The relatively large share of residential properties is positive for the transaction given the better liquidity of such properties, reflected in Scope's lower fire-sale discount assumptions (see Figure 9).

Figure 16: Distribution by type of collateral



Sources: Transaction datatape; calculations by Scope Ratings

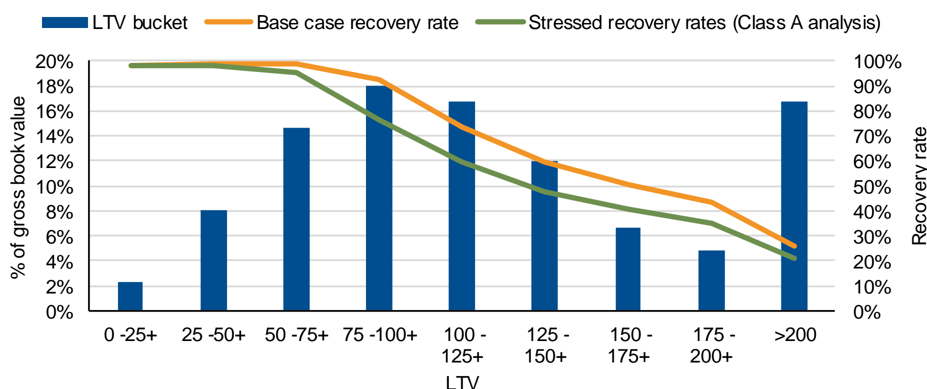
Recovery rate assumptions reflect portfolio's LTV distribution

4.2.4. Collateral valuations and Scope's specific recovery rate assumptions

Figure 17 shows the secured loans' distribution by loan-to-value bucket as well as Scope's recovery rate assumptions for each LTV bucket (under Scope's base case and under the rating-conditional stresses applied for the analysis of the class A notes). This results in weighted average recovery rates for the secured loans of 55.1% and 48.0%, under Scope's base case under the class A rating-conditional stress, respectively.

All else equal (e.g. for two portfolios with equivalent loan-to-value ratios on an aggregated basis), collateral is less beneficial if its value is skewed towards low loan exposures. This is because, on a loan-by-loan basis, recovery proceeds are capped by the minimum of the loan's GVB and mortgage value. This partly explains why recovery rates flatten at low loan-to-value buckets.[4]

Figure 17: Secured loans distribution by LTV and Scope's transaction-specific secured recovery rate assumptions



Sources: Transaction datatape, calculations by Scope Ratings

[4] Another reason is that syndicated loans are concentrated in the low LTV buckets for this portfolio. The reported LTVs of syndicated loans are downward-biased because the loan amount reflects only the syndicated percentage whereas the appraisal reflects the total collateral value.

4.2.5. Loan seasoning

Ageing of unsecured portfolio reduces expected recoveries

The weighted average time since default is around 3.5 years for unsecured exposures. The pool's ageing reduces the expected recoverable amount of unsecured loans significantly, since most recoveries are concentrated in the first years after a default, according to historical vintage data.

Figure 18: Unsecured portfolio seasoning distribution as of cut-off date

Sources: Transaction datatape; calculations by Scope Ratings

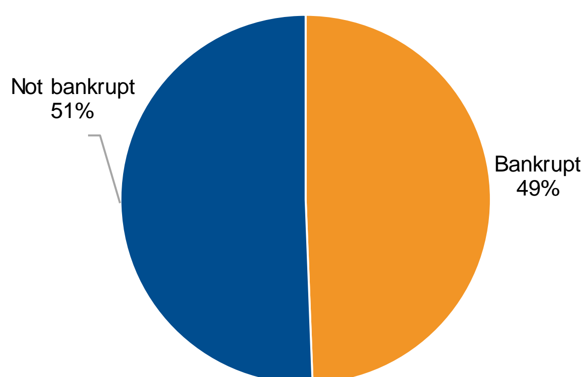
4.2.6. Borrower status

Figure 19 below shows the main legal proceedings for each loan (one loan can have several), as assumed by Scope based on the transaction's datatape. About 11.7% of the loans have either no ongoing legal proceeding or the nature of the proceeding is unknown. We have conservatively assumed that these positions will fall into bankruptcy.

Bankruptcies result in lower recoveries than non-bankruptcy proceedings

Relative to non-bankruptcy processes, bankruptcy processes are generally more complex, have a longer duration and are costlier. Bankruptcies also result in lower expected recoveries for unsecured exposures, given the focus on liquidating assets rather than maintaining borrowers as a going concern.

Figure 19: Borrower status assumptions



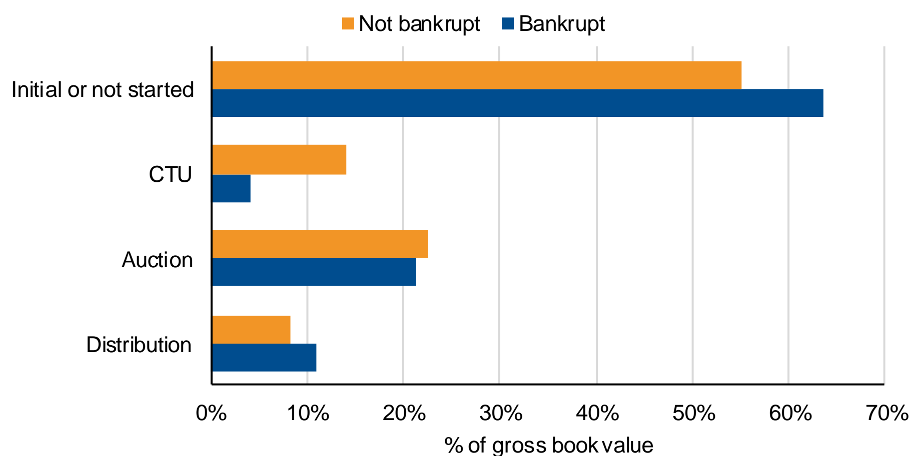
Sources: Transaction datatape; calculations by Scope Ratings

4.2.7. Recovery stage of secured exposures

High share of proceedings in initial stages drive relatively long recovery timing assumptions

A large portion of the secured loans is in initial stages, which partly explains the relatively long expected weighted average life of portfolio collections. Figure 20 below shows the stage of legal proceedings for bankruptcies and non-bankruptcies in relation to secured loans.

Figure 20: Secured recovery stage by borrower status



Sources: Transaction datatape; calculations by Scope Ratings

5. Key structural features

5.1. Combined priority of payments

The issuer's available funds (i.e. collection amounts received from the portfolio, the cash reserve and payments received under the interest rate cap agreement) will be used in the following simplified order of priority:

1. Servicer fees and other issuer counterparty fees, taxes and transaction expenses
2. Interest on the limited-recourse loan
3. GACS premium, provided the GACS guarantee is in place
4. Recovery expenses reserve replenishment
5. Interest on class A notes
6. Any other amounts payable under the GACS guarantee
7. Cash reserve replenishment
8. Principal on the limited recourse loan
9. Margin interest (6%) on class B notes, provided no subordination trigger is breached
10. Principal on class A notes
11. Euribor component (floored at zero) of class B interest and, if any class B subordination trigger is breached, class B margin interest
12. Principal on class B and deferred servicer performance fees, if any
13. Other junior payments

Full class B interest deferral is an unlikely event

The class B subordination triggers may be relatively ineffective at protecting the senior noteholders as the subordination event is reversible. At any time during the transaction life both triggers are jointly cured, all class B interest amounts due and unpaid at the preceding payment dates will be paid senior to class A principal. The subordination of the class B interest margin component would be triggered if a) the cumulative collection ratio[5] falls below 70%, or if b) the present value cumulative profitability ratio[6] falls below 70%.

[5] 'Cumulative collection ratio' is defined as the ratio between i) the cumulative net collections since the cut off date; and ii) the net expected collections. Net collections are the difference between the gross collections and the recovery expenses.

[6] 'Present value cumulative profitability ratio' is defined as the ratio between i) the sum of the present value (calculated using an annual rate of 3.5%) of the net collections of all receivables relating to closed positions, and ii) the sum of the target price (as defined in the servicers' base case scenario of the business plan) of all

Scope ratings do not address the GACS guarantee

The GACS guarantee would ensure timely payment of interest and ultimate payment of principal by final maturity. Scope's rating does not give credit to the GACS guarantee, but it considers the potential cost (i.e. GACS premium) if added to the structure at a later stage.

Non-timely class A interest payment would trigger accelerated waterfall

Non-payment of timely interest on the senior notes (implying the GACS guarantee is not in place) among other customary events such as issuer unlawfulness, would accelerate the repayment of class A through the full subordination of class B payments.

5.2. Servicing fee structure and alignment of interests

5.2.1. Servicing fees

Alignment of servicer and noteholder interests

The servicing fee structure links the portfolio's performance with the level of fees received by the servicer, which mitigates potential conflicts of interest between the servicer and noteholders. Incentive fees constitute most of the expected servicing fees.

The servicers will be entitled to: i) a base fee, calculated at each payment date on the outstanding portfolio's gross book value; and ii) a performance fee, calculated at each payment date on the period's collections net of legal costs (collectively, the servicing fees).

In the case of underperformance, a portion of the fees will be paid on a junior position in the priority of payments. The servicer is therefore incentivised to maximise recoveries and comply with the initial business plan.

5.2.2. Servicer monitoring

Monitoring function protects noteholders' interests

An overview of the servicers' activities and calculations, prepared by the monitoring agent (Securitisation Services), mitigates operational risks and moral hazard that could negatively impact the interests of noteholders. This risk is further mitigated by the discretionary servicer termination event should the servicer underperform.

Under the servicing agreement, the servicer is responsible for the servicing, administration, collection of receivables as well as the management of legal proceedings. The monitoring agent will verify the calculations of key performance ratios and amounts payable by the issuer, as well as perform controls based on random samples of loans.

The monitoring agent will report to a committee that will represent the junior and mezzanine noteholders' interests. The committee can authorise the revocation of the servicer, and its replacement with another party, subject to the approval of the representative of noteholders. The monitoring agent can also authorise the sale of the receivables, the closure of debt positions, as well as the payment of additional costs and expenses related to recovery activities.

5.2.3. Servicer termination events

Back-up arrangements mitigate servicing disruption risk

Securitisation Services would step in as master back-up servicer in the event of a servicer termination event and, as the monitoring agent, would also be responsible for appointing a suitable replacement for the special servicer.

A servicer termination event includes insolvency, failure to pay due and available amounts to the issuer within two business days, failure to deliver or late delivery of a semi-annual report, unremedied breach of obligations, unremedied breach of representation and warranties, and no longer being legally eligible to perform obligations under the servicing agreement. The servicer can also be substituted owing to consistent underperformance from the sixth collection period.

receivables relating to closed positions. 'Administrative closure of the debt position' is defined as the cancellation of the debt position in the servicers' IT/computer system.

5.3. Liquidity protection

Cash reserve protects liquidity of the senior noteholders

A cash reserve of around 4% of the outstanding balance on class A and B notes will be funded at closing through a limited-recourse loan provided by the Banco BPM.

The cash reserve will amortise with no floor during the life of the transaction. The target amount of cash reserve at each payment date will be equal to 4% of the outstanding balance of class A and B notes.

The cash reserve will be available to cover any shortfalls in interest payments on the class A notes as well as any items senior to them in the priority of payments.

Class B will not benefit from any liquidity protection.

5.4. Interest rate hedge

On the asset side, due to the non-performing nature of the securitised portfolio, the issuer will not receive regular cash flows and the collections will not be linked to any defined interest rate. On the liability side, the issuer will pay a floating coupon on the notes, defined as six-month Euribor plus a 6% fixed margin.

An interest rate cap, with a progressively increasing strike as shown in Figure 21, and a notional balance as shown in Figure 22, partially mitigates the risk of increased liabilities on the notes due to a rise in Euribor levels. The deferral of the class B interest Euribor component is another layer of protection against the risk of increasing Euribor rates for the class A notes.

Cap notional does not fully mitigate interest rate risk under a recovery timing stress

A delay in recoveries beyond Scope's stressed recovery timing vector would increase interest rate risk exposure, as it would widen the gap between the transaction's interest rate cap notional and the outstanding principal of the rated notes, shown in Figure 22. For the analysis of the class A notes, Scope stressed the Euribor forward curve as shown in Figure 21.

Figure 21: Interest rate cap

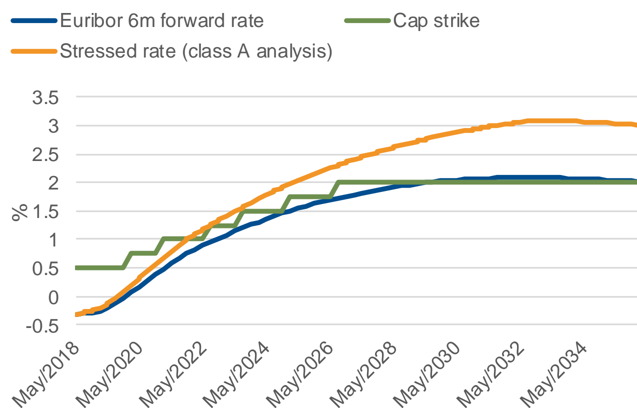
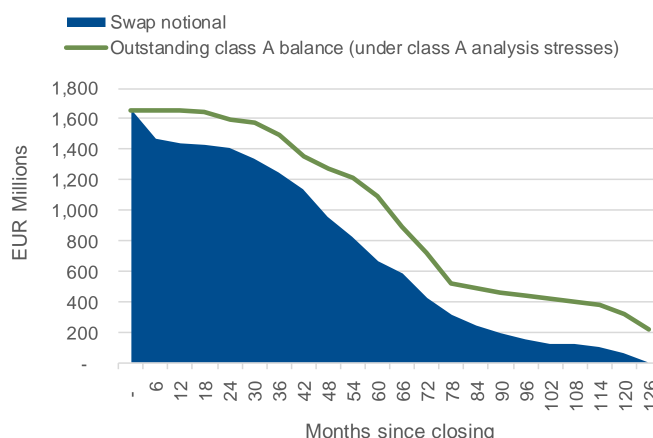


Figure 22: Cap notional vs. outstanding class A notes



Sources: Transaction documents, Bloomberg and Scope Ratings

6. Cash flow analysis and rating stability

Scope's cash flow analysis considers the structural features of the transaction

Scope has analysed the transaction's specific cash flow characteristics. Asset assumptions have been captured through rating-conditional gross recovery vectors. The analysis captures the capital structure, an estimate of legal costs based on the servicer's

business plan, and senior fees of about EUR 200,000 annually. We have taken into account the reference rate payable on the notes based on the six-month Euribor forward curve, considering the progressive cap rates of the swap.

Scope's ratings reflect expected losses over the instrument's weighted average life

The BBB rating assigned to the class A notes reflects expected losses over the instrument's weighted average life commensurate with the idealised expected loss table reported in Scope's General Structured Finance Ratings methodology.

Scope tested the resilience of the ratings against deviations from expected recovery rates and recovery timing. This analysis has the sole purpose of illustrating the sensitivity of the ratings to input assumptions and is not indicative of expected or likely scenarios. Scope tested the sensitivity of the analysis to deviations from the main input assumptions: i) recovery rate level and ii) recovery timing.

The following shows how the results for class A change compared to the assigned credit rating in the event of:

- a decrease in secured and unsecured recovery rates by 10%: 3 notches; and
- an increase in the recovery lag of two years, negative: 2 notches

7. Sovereign risk

No mechanistic cap

Sovereign risk does not limit any of the ratings. The risks of an institutional framework meltdown, legal insecurity or currency convertibility problems, due to Italy's hypothetical exit from the Eurozone, are not material for the notes' rating.

For more insight about Scope's fundamental analysis about the Italian economy please refer to the agency's rating report on the Republic of Italy, dated 30 June 2017.

8. Counterparty risk

Counterparty risk does not limit the transaction's rating

The transaction is mainly exposed to counterparty risk from the following counterparties: Banco BPM and Banca Popolare di Milano, the two originators, regarding representation and warranties and the eventual payments that might be made by the borrowers, ii) Prelios, the servicer, iii) Securitisation Services, the back-up servicer, monitoring agent, calculation agent, and representative of noteholders, iv) Banco BPM, the interim collection account bank, v) BNYM, the issuer's account bank and paying agent, vi) Banco Santander, one of the two swap counterparties, and vii) Mediobanca, the other swap counterparty. In Scope's view, none of these exposures limits the maximum ratings achievable by this transaction.

Scope factored counterparty replacement triggers implemented in the transaction into its analysis, and relied on Scope's rating on Banco Santander (AA-/S-1+/Stable) and publicly available ratings on The Bank of New York Mellon, Banco BPM and Mediobanca

Most servicer collections will be paid directly to the issuer account bank held with BNYM, which will also hold the cash reserve. The issuer will open with the Italian account bank the interim collection account (to deposit the amounts received by the Issuer by means of checks and promissory notes), and the recovery expenses reserve account (from which the recovery expenses will be paid).

The will be no rating trigger for the replacement of the Italian account bank. Scope considers that the credit risk is mitigated by the limited expected amounts credited to these accounts.

8.1. Servicer disruption risk

A servicer disruption event may have a negative impact on the transaction's performance. The transaction incorporates servicer monitoring, back-up and replacement arrangements that mitigate operational disruption (see section 5.2).

8.2. Commingling risk

Limited commingling risk

Commingling risk is limited, as debtors will be instructed to pay directly to an account in the name of the issuer. In limited cases where the servicer received payments from a debtor, the servicer would transfer the amounts within two business days.

8.3. Claw-back risk

Limited claw back risk

The originators have provided: i) a good standing certificate from the Chamber of Commerce, ii) a solvency certificate signed by a representative duly authorised, and iii) a certificate from the bankruptcy court (tribunale civile – sezione fallimentare) confirming that the originator is not subject to any insolvency or similar proceedings. This mitigates claw-back risk, as the issuer should be able to prove that it was not aware of the issuer being in a state of insolvency as of the transfer date.

Assignments of receivables made under the Italian Securitisation Law are subject to claw-back in the following events:

(i) pursuant to article 67, paragraph 1, of the Italian Bankruptcy Law, if the bankruptcy declaration of the relevant originator is made within six months from the purchase of the relevant portfolio of receivables, provided that the sale price of the receivables exceeds the value of the receivables by more than 25% and the issuer is unable to demonstrate that it was unaware of the originator's insolvency, or

(ii) pursuant to article 67, paragraph 2, of the Italian Bankruptcy Law, if the adjudication of bankruptcy of the relevant originator is made within three months from the purchase of the relevant portfolio of receivables, provided that the sale price of the receivables does not exceed the value of the receivables by more than 25% and the originator's insolvency receiver can demonstrate that the issuer was aware of the originator's insolvency.

8.4. Enforcement of representations and warranties

Representations and warranties limited by time and amount

The issuer will rely on the representations and warranties, limited by time and amount, provided by the originators in the transfer agreement. If a breach of a representation and warranty materially and adversely affects a loan's value, the originators may be obliged to indemnify the issuer for damages within 10 business days of the notification. However, the total indemnity amount will be capped to a maximum of 27% of the portfolio purchase price, and will be only be paid out for claims within two years since the closing date. In addition, the minimum claimable amount is EUR 750,000, on a portfolio basis, and EUR 10,000, on a single loan basis.

9. Legal structure

9.1. Legal framework

Transaction governed by Italian law

The transaction documents are governed by Italian law, whereas English law governs the interest cap agreements and the deed of charge.

The transaction is fully governed by the terms in the documentation and any changes are subject to the risk-takers' consent, with a superior voting right of the most senior noteholders at the date of the decision.

9.2. Use of legal opinions

Scope had access to the legal opinions produced for the issuer, which provide comfort on the legally valid, binding and enforceable nature of the contracts.

10. Monitoring

Continuous rating monitoring

Scope will monitor this transaction based on the performance reports as well as other public information. The ratings will be monitored continuously and reviewed at least twice a year, or earlier if warranted by events.

Scope analysts are available to discuss all the details of the rating analysis, the risks to which this transaction is exposed, and the ongoing monitoring of the transaction.

11. Applied methodology

For the analysis of the transaction Scope applied its General Structured Finance Instruments Rating Methodology, and its Methodology for Counterparty Risk in Structured Finance, both available on www.scoperatings.com

I. Summary Appendix – Deal comparison

Transaction	Red Sea SPV	Aragorn NPL 2018	Siena NPL 2018	Bari NPL 2017	Elrond NPL 2017
Closing	Jun-18	Jun-18	May-18	Dec-17	Jul-17
Originators	Banco BPM, BPM	Creval	MPS	BPB, CRO	Creval
Master servicer		Italfondiario	Credito Fondiario	Prelios	Prelios
Special servicer	Prelios	Cerved, Credito Fondiario	Juliet, Italfondiario, Credito Fondiario, Prelios	Prelios	Cerved
General portfolio attributes					
Gross book value (EUR m)	5,113	1,676	23,939	345	1,422
Number of borrowers	12,651	4,171	79,669	1,565	3,712
Number of loans	33,585	8,289	545,939	4,569	6,951
WA seasoning (years)	3.8	2.5	4.4	4.5	3.7
WA seasoning (years) - unsecured portfolio	3.5	3.2	4.8	N/A	N/A
WA LTV buckets (% or secured portfolio)					
bucket [0-25]	2.3	2.0	5.7	N/A	3.6
bucket [25-50]	8.1	4.2	12.4	N/A	11.1
bucket [50-75]	14.7	8.2	16.8	N/A	13.7
bucket [75-100]	18.1	13.9	17.0	N/A	19.6
bucket [100-125]	16.7	22.3	13.4	N/A	24.6
bucket [125-150]	12.0	17.9	8.3	N/A	8.6
bucket [150-175]	6.6	11.9	5.3	N/A	4.8
bucket [175-200]	4.8	3.7	3.9	N/A	1.6
bucket > 200	16.7	16.0	17.1	N/A	12.5
Cash in court (% of total GBV)	3.2	0.5	N/A	N/A	2
Loan types (% of total GBV)					
Secured first-lien	70.6	67.3	41.6	53.6	66.4
Secured junior-lien	1	8.1		2.5	7.6
Unsecured	28.4	24.6	58.4	43.9	26.0
Syndicated loans	1.4	1.8	5.7		
Debtors (% of total GBV)					
Individuals	28.4	9.9	19	12	12.7
Corporates or SMEs	71.6	90.1	81	88	87.3
Procedure type (% of total GBV)					
Bankrupt	49.4	55.0	36.6	46.5	57.6
Non-bankrupt	50.6	45.0	63.4	53.5	42.4
Other	-	-	-	-	-
Not started					
Borrower concentration (% of total GBV)					
Top 10	1.8	8.3	2.1	28.2	13.4
Top 100	9.1	39.5	9.5	69	42.4
Collateral distribution (% of appraisal values)					
North	67.8	58.5	35.9	18.3	61.6
Centre	20.7	18.4	36	14.1	14.6
South	11.4	23.1	28.1	67.6	23.8
Collateral type (% of appraisal values)					
Residential	54.8	43.4	28.2	43	32.6
Commercial	15.4	22	71.8	40	32.4
Industrial	9.4	15.3			23.2
Land	8.6	0.0		18	8.7
Other or unknown	11.8	19.3			3.4
Valuation type (% of appraisal values)					
Full or drive-by	74.0	96.1	10	96.31	70.8
Desktop	14.5	1.2	65		4.0
CTU	11.5	2.7	15	3.69	23.6
Other	0	0	10	0	0.5
Secured portfolio procedure stage (% of GBV)					
Initial	64.4	66.6	52.6	55.5	36.1
CTU	9.1	23.4	5.4	14.2	10.7
Auction	21.3	4.7	35.2	26.5	36.4
Distribution	5.2	5.5	6.7	3.8	16.8
Summary of assumptions (BBB rating conditional stress)					
Remaining lifetime recovery rate (%)					
Secured (=net LTV after all stresses)	62.8	48.3	58.6	51.8	61.7
Unsecured	12.3	16.8	9.2	11.1	13.7
Total	**48.0**	**40.6**	**29.8**	**33.1**	**47.1**
Weighted average life of collections (years)					
Secured	6.8	7.9	N/A	N/A	4.8
Unsecured	4.1	4.2	N/A	N/A	3.1
Total	**6.6**	**7.9**	**N/A**	**N/A**	**4.6**
Structural features					
Liquidity reserve (% of class A notes)	4.375 (% of A and B)	5.0	3.5	4.0	4.0
Class A Euribor cap strike	0.5-2.0%	0.0-0.1%	0.5-3.0%	0.10%	0.50%
Class A					
% of GBV	32.5	30.5	12.1	25.3	33.0
Credit enhancement	67.5	69.5	87.9	74.7	67.0
Class B					
% of GBV	3	4.0	3.5	3.1	3.0
Credit enhancement	64.5	65.5	84.4	71.6	64.0
Final rating					
Class A	BBB	BBB-	BBB+	BBB	BBB-
Class B	NR	B	NR	B+	B+

Transactions' preliminary data tapes; calculations and assumptions by Scope Ratings. Closing portfolio stratifications might show non-material deviations.

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