

Renewed GACS scheme will reduce Italian NPL ABS issuance



The renewal of Italy's GACS1 guarantee scheme supports efforts by Italian banks to continue decreasing their stock of bad loans. Scope forecasts that around EUR 25bn NPLs in terms of gross book value (GBV) will be securitised in GACS-eligible securitisations in 2019.

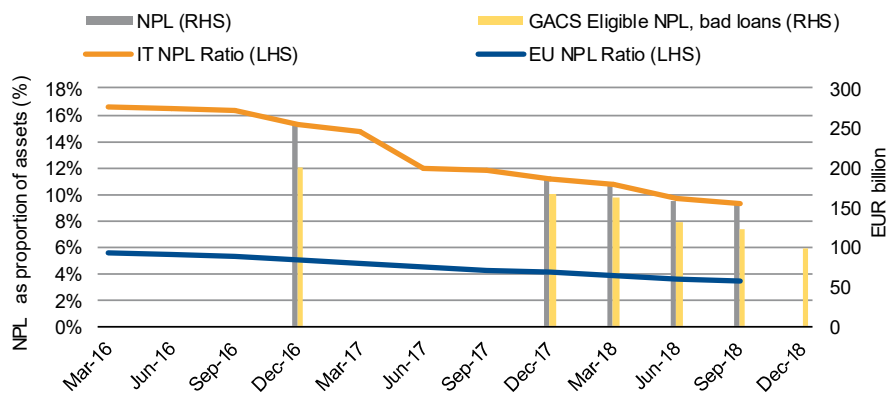
The renewal of the GACS scheme for two additional years is a driver for NPL securitisation in Italy in 2019 and beyond, although it is less important than the previous version of the scheme. The renewed scheme contains some restrictions on structures, which will increase the protection for senior notes. Scope expects that around EUR 25bn in terms of portfolio GBV will be securitised in 2019 (including the EUR 8.4bn securitised in February before the renewal). This is significantly less than the approximately EUR 45bn which was securitised in 2018 (in 14 transactions all rated by Scope) and depends on three main factors: (i) the amount of NPLs that can be disposed decreased significantly in 2018, (ii) the inflow of new NPLs has decreased to pre-crisis levels; (iii) the renewal of the GACS scheme contains some restrictions, which reduce the attractiveness of securitisations to banks.

Lower stock of securitisable bad loans and reduced take-up rate

In 2018, Italian banks made extensive use of GACS-eligible securitisations to dispose of non-performing loans. Scope rated 14 GACS-eligible securitisations, amounting to a total GBV of around EUR 45bn. Figure 1 illustrates the reduction in the NPL ratio² from around 15.3% (or the equivalent of approximately EUR 254bn) at the end of 2016 to 9.4% (EUR 153bn) by the end of Q3 2018, which is still more than double of the EU average of 3.4%. As the GACS scheme only allows the inclusion of bad loans (sofferenze), Figure 1 also shows the reduction in bad loans from around EUR 200bn at the end of 2016 to around EUR 100bn in the end of 2018. The EUR 45bn of NPLs disposed with the GACS scheme in 2018 represents around 27% of the bad loans outstanding at the end of 2017.

Due to the more restrictive criteria for the GACS securitisations, Scope expects that only 15%-17% of the bad loans outstanding at end of 2018 will be securitised in 2019 under the renewed GACS scheme.

Figure 1: Historical development of the NPL ratio Italian banking system



Source: European Banking Authority Risk Dashboard and Bank of Italy Banks and Money National Data

¹ Garanzia sulle Cartolarizzazioni delle Sofferenze

² Since March 2015, the Bank of Italy applies the following definition of non-performing loans, in line with the European Commission regulation: 1) Bad loans (sofferenze), 2) Unlikely to pay (inadempienze probabili), 3) Overdrawn and/or past-due exposures (esposizioni scadute e/o sconfinanti deteriorate).

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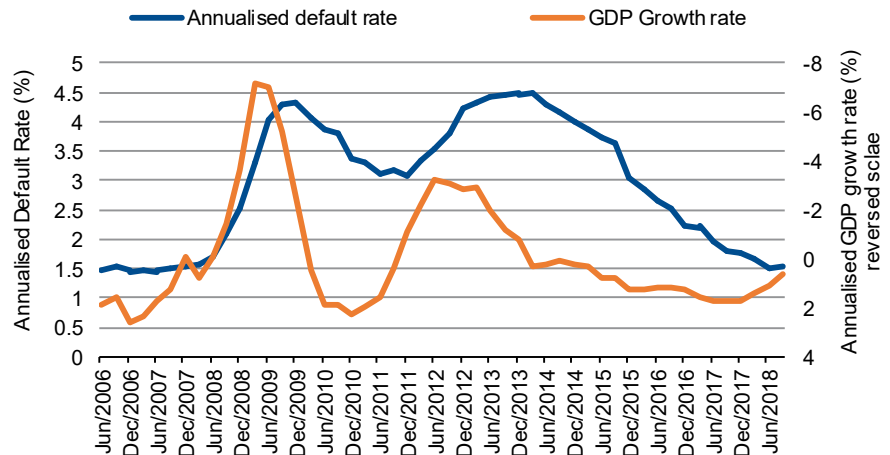
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The default rates observed in 2018 are back at pre-crisis levels of 2006–2007

Reduced inflow of new bad loans decreases securitisable amount

The inflow of new bad loans increased dramatically after the global financial crisis of 2008–2009 and continued to stay at elevated levels through the prolonged recession in 2011–2014 before it started to decrease. The default rates observed in 2018 are back at pre-crisis levels of 2006–2007, which indicates that the amount of new bad loans that can be eligible for GACS securitisations will continue to be limited in 2019.

Figure 2: Historical development of the NPL ratio Italian banking system



Source: Bank of Italy table TRI30601 and OECD

The market will have to adapt to some of the new key elements in the GACS scheme

More restrictive GACS criteria lead to reduced usage

The market will have to adapt to some of the new key elements in the GACS scheme, which will delay and to some extent hamper usage of the renewed GACS scheme. Required changes to the structure of transactions will have the largest impact on future usage of the scheme, while the change to the pricing mechanism is less important.

The first key change is that if cumulative collections are below the business plan for two consecutive payment dates, after the guarantee has been executed, then the servicers must be substituted. The GACS-eligible transactions done in the last two years already contain a servicer-substitution event in case of under-performance, but it normally only kicks in after 2–3 years after issuance of the notes, in order for servicer performance to stabilise after the initial on-boarding process. Servicing activities in NPL transactions are key for performance, and they are more complex and time-consuming compared to other type of assets. So, we expect that cash flows recovered from the pool are reduced during a servicer-substitution phase.

All other things being equal, more back-loaded business plans will lead to a lower sale price for the NPL portfolio

We expect that as a reaction to this structural requirement, servicers will craft more back-loaded business plans to avoid the risk of a servicer substitution event occurring shortly after the notes are issued. This will lead to servicer business plans more aligned with Scope assumptions, which have typically been significantly more backloaded than the servicers'. All other things being equal, more back-loaded business plans will lead to a lower sale price for the NPL portfolio, which could negatively impact the attractiveness of the GACS scheme for banks.

The second key change is that if cumulative collections fall below 90% of the level foreseen in the business plan, at least 20% of the servicing fees have to be subordinated to full repayment of the senior notes or if earlier, until the date when cumulative collections returns above 100% of levels foreseen in the business plan.

Servicing fee subordination upon breach of triggers is credit positive for senior notes

Most GACS-eligible transactions already contain some kind of deferral or haircut on the servicing fees, but the new feature is generally stronger than what has been seen so far. Given that servicing fees are paid senior in the waterfall, this change is credit-positive for the senior notes and it also improves the alignment of interest between servicers and noteholders. On the other hand, we expect that servicers will be slightly more cautious when crafting their business plans, which could affect the sale price for the NPL portfolio, and potentially also reduce the interest for servicers to participate in GACS-eligible securitisations over portfolio sales, where the different deferral and haircut mechanisms can be structured in a more flexible way.

Mezzanine notes interest must be subordinated upon trigger breach

The third key change is that interest on mezzanine notes will be automatically subordinated to principal payments on senior notes if cumulative collections are less than 90% of the business plan. Once interest on the mezzanine notes has been subordinated, it will only be paid if the cumulative collections ratio returns above 100% of the business plan, or if the senior notes have been fully repaid.

The new subordination mechanism in the decree is more protective for senior notes

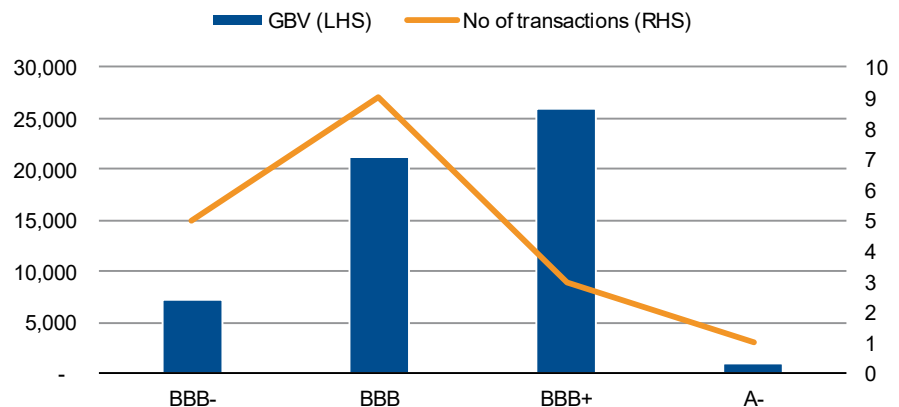
Except for Elrond NPL 2017 Srl, all other GACS-eligible transactions rated by Scope contain a mechanism whereby interest on the mezzanine notes can be subordinated to principal payments on the senior notes. The trigger level for the subordination is generally set between 70% and 95% of the business plan, with most of the transactions at the 90% level. Therefore, the level indicated in the law decree is aligned with current levels in the market. The main difference is that in current structures, once collections have gone back above the subordination level (normally at 90%), all interest accrued on the mezzanine notes during the subordination period is paid senior to principal on the senior notes, while for new GACS-eligible transactions this would only occur if the cumulative collections return above 100% of the business plan.

The new subordination mechanism in the decree is therefore more protective for senior notes, which is credit positive. On the other hand, the increased risk that mezzanine notes will be subordinated will reduce investor appetite for these notes.

Senior notes have to be rated at least BBB

The fourth key change is that for transactions to be GACS-eligible, the senior notes have to be rated at least BBB, compared to BBB- in the previous version of the scheme. As illustrated by Figure 3, in 13 out of the 18 GACS-eligible transactions rated by Scope between 2017 and 2019, the senior notes were rated BBB or higher.

Figure 3: GACS-eligible transactions grouped by rating on the senior notes



Source: Scope Ratings

Finally, the new decree contains some changes to how the fee for the guarantee on the senior note is calculated. The guarantee fees will be calculated based on the average daily CDS spreads over a two-month period, instead of six months, which makes it more



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It takes 4-6 months to prepare and complete GACS-eligible transactions

volatile. The cost will also slightly increase due to a change in certain time-linked multipliers. We do not expect these technical changes to have any significant impact on the usage of the GACS scheme.

Next GACS-eligible transaction expected in the autumn

Two GACS-eligible securitisations, backed by total GBV of around EUR 8.4bn, were completed in February before the end date of the previous GACS scheme. The lead-time to prepare and complete GACS-eligible transactions is generally four to six months. In addition, new elements in the decree can also affect immediate interest in completing new transactions. We therefore expect that most of the additional issuance, reaching our forecast of EUR 25bn in GACS-eligible transactions, will materialise in late summer or autumn.



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