Italian UTP sales to pick up in 2019; securitisations to follow

Italian banks could dispose of between EUR 13bn and EUR 18bn in Unlikely to Pay (UTP) loans in 2019, reflecting a cautious sale approach in the short to medium term.

In 2018, UTP loan sales represented just 1% of the volume of Italian banks' bad loan disposals, even though UTP stock represented 69% of bad loans in terms of gross book value. The UTP market is at the beginning of its cycle, just as the market for bad loans was in the immediate post-crisis period.

Scope expects that UTP true-sale securitisations will emerge, once current market challenges are overcome. The financial attractiveness of UTP securitisations is currently limited by the lack of a guarantee scheme (such as GACS) to reduce the bid-ask gap, the absence of specialised UTP market operators, and information asymmetry.

The development of hybrid servicing models and the reduction of information asymmetry through the availability of alternative sets of information for investors could stimulate the development of a UTP securitisation market in the medium to long term.

Alternative strategies to UTP disposals and securitisations might see corporate restructurings carried out by specialised funds, or the establishment of strategic partnerships between banks and servicers, potentially including UTP outsourcing.

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Italian UTP sales to pick up in 2019; securitisations to follow

1. Overview of UTP and Bad Loan markets

Bad loan market's strong dynamism contrasts with still-embryonic UTP market

The Italian market for bad loans was very dynamic in 2018. The main factors boosting banks' disposals were 1) the evolution of the regulatory regime for bad loan management and provisioning, 2) a relatively mature and transparent market for investors and originators, and 3) the renewal of the GACS law[1].

EUR 101bn of gross bad loans were disposed[2] of in 2018. 45% were securitised through 14 GACS-eligible transactions[3]. Bad loans were sold at a weighted average price[4] of 26% of their gross book value.

Intense market activity has caused a significant decrease in Italian banks' stock of bad loans (-40%[5] since Q4 2016), which has prompted some investors to start looking to another, still relatively unexplored asset class: unlikely-to-pay (UTP) exposures.

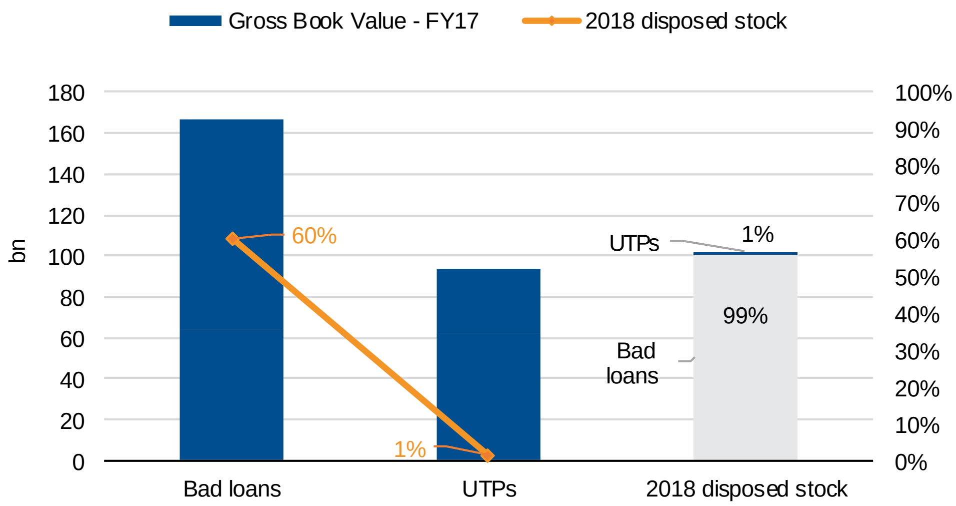
Even though the market for this type of exposure is still developing, a few transactions have occurred. Both single names and concentrated portfolios have been sold, generally secured by real estate assets.

2018 UTP transactions represented only 1% of bad loans sales

In 2018, EUR 1.3bn of UTPs were sold[6] through four disposals at an average price of 40%-43%[7] of their gross book value. Yet even though UTPs represent 69% of the bad loan stock of Italian banks in terms of gross book value (EUR 83bn vs EUR 120bn as of September 2018[8]), UTP transactions represented only 1% of the bad loan sales in terms of disposed amounts.

In 2018, while 60% of 2017 FY[9] bad loans were disposed of, only 1% of the 2017 FY UTPs were sold (as shown in the figure below).

Figure 1 : Bad loan and UTP disposals: 2018



Sources: Public data, Scope Ratings calculations

[1] The GACS law came into force on Feb 2016; it was renewed in Sep 2017 and subsequently in Sep-18. It expired on 6 Mar 2019. As envisaged in the D.L. n.22, Gazzetta Ufficiale n.71 of 25 March 2019., GACS scheme will be renewed for a period of 24 months up to 36 months.
[2] Scope calculations based on public data.
[3] Please refer to Appendix I.
[4] Scope's calculations based on public data.
[5] Considering the reference period ranging from Q4 2016 to Q3 2018.
[6] Considering only portfolios purely or mainly composed by UTPs and excluding bank bailouts.
[7] Scope calculations based on public data.
[8] As of Sep-18, Bank of Italy Statistics, TRI30266.
[9] "FY" stands for "Final Year".

2. UTP management strategies

2.1. Strategic disposal approach in the short to medium term

UTP disposals could be between EUR 13bn and EUR 18bn in 2019

Scope expects banks will continue to adopt a cautious disposal approach for UTPs, either via single-name or portfolio transactions, following limited progress in 2018. Banks' disposals will be mainly driven by an opportunistic rationale.

More than EUR 4bn of UTP transactions have already been announced for 2019. We expect total disposals to be in a range of EUR 13-18bn, based on historical UTP inflows and outflows.

2017 data from the top 10 Italian banks on gross outflows and inflows of UTPs show that only half of 2016 FY UTPs remained in UTP status. 16% went into the "bad loans" segment, 7% regained "performing" status, while the residual 27% was collected or was related to other outflows[10.]

In 2016, an even higher percentage of UTPs (21%) gained "bad loan" status, while 56% of 2015 FY stock remained in the UTP category. The residual 23% was collected or related to other outflows.

This suggests that between EUR 13bn and EUR 18bn[11] of gross UTPs could hit default status during 2019[12,] and therefore be sold in the market with the expectation of being managed as bad loans. We estimate that between EUR 41bn and EUR 47bn[13] of UTPs will remain in their current status. It is likely that a certain portion of these exposures will be sold, depending on banks' considerations in terms of economics and reputational risk, which might derive from the disposal of loans to big borrowers.

2.2. Challenges of the UTPs securitisation market

The Italian non-performing loan (NPL) securitisation market has been very active recently, with EUR 45bn of GACS-eligible securitisations[14]. However, there have not yet been any public UTP securitisations. The current information asymmetry and the relatively weak presence of specialised market operators able to manage UTP exposures have contributed to a delay in the development of a UTP securitisation market.

2.2.1. Asymmetry of information

Information asymmetry can be reduced driving investors' confidence in the asset class

Reduced information asymmetry and better instruments to perform risk/return analysis would be beneficial for the market, driving up investors' comfort in the UTP asset class. In fact, while investors and servicers already have their own sets of historical performance data for bad loans (given their own transaction track records and proprietary market data), there is still scarce historical information on UTPs.

Migration matrices and historical recovery curves can provide additional information about UTPs

To reduce this asymmetry and foster investors' confidence in the asset class, alternative sources of information can be used, subject to market participants' consent. For example, banks' migration matrices, tracking the flow of exposures in and out of non-performing classification can be analysed, along with additional statistics deriving from banks' monitoring tools for non-performing exposures.

[10] Data source: The Italian NPL Market, Entering a New Era, PwC, Dec 18. 2017 data: UTPs inflows include (i) 14% from performing exposures, (ii) 5% from other bad loans and (iii) 15% of other inflows. 2016 data: UTPs inflows include (i) 16% from performing exposures, (ii) 8% from other bad loans and (iii) 9% of other inflows.
[11] Assuming the gross stock of UTPs, as of Sep- 18, might flow at a rate of 16%-21% (analogously to 2017/2016 outflows data for the top 10 Italian Banks), to a bad loan status.
[12] EUR 13bn-18bn could be referred as a proxy of those UTP exposures which, having the worst credit quality, would be more similar to the bad loan asset class (in terms of potential recoveries and management strategies) and therefore more likely to be disposed of, given the presence of a pre-established market of servicers and based on banks' interests.
[13] Assuming that the gross stock of UTPs, as of Sep- 18 might not change status at a rate of 50%-56% (analogously to 2017/2016 outflows data for the top 10 Italian Banks).
[14] Please refer to Appendix I.

Analogous to certain bad loans securitisations, historical recovery/performance curves can also be shared in case of UTPs, improving investors' capability to price and analyse securitisations.

2.2.2. Hybrid credit market operators

Hybrid credit market operators are expected to strengthen their presence in the UTP market

While bad loans can be considered a static asset class, given the default status of debtors, this is not applicable to UTP exposures. As shown by Italian banks' historical inflows and outflows, UTP status can dynamically change over time, following the financial evolution of debtors. Given the intrinsically different nature of UTPs and bad loans, servicers may need to upgrade their current set-up, creating ad hoc internal divisions able to proactively manage UTP exposures.

Just as with bad loans, UTP management requires robust recovery and legal skills. Unlike bad loans, strong restructuring skills are fundamental, especially for big corporate exposures. These skills are usually found at private equity funds, and in the M&A and restructuring departments of international banks. For the development of a UTP securitisation market, hybrid credit market operators will be needed, combining the current structures of servicers with the corporate finance and lending capabilities of banks.

Restructuring big-ticket UTPs calls for capital and liquidity for investment purposes. The establishment of partnerships between servicers and banks or funds might not be the only feasible strategy. Acquiring a banking license (i.e. as done by NPL servicer Guber), adopting the business model of the "challenger bank" (as seen with the tie-up between Spaxs S.p.A. and Banca Interprovinciale S.p.A. to create Illimity Bank[15]), or collaborating with funds might allow market operators to offer specialty services, including the provision of new finance, integrated with the typical servicing skills for the bad loan segment.

2.3. Scope expects true sale securitisations to occur in the medium to long term

In addition to the challenges discussed above, the lack of a guarantee scheme weakens the economic interest of UTP securitisations, both for originators and investors.

The GACS renewal[16] will most probably not cover UTP exposures. Furthermore, GACS will be renewed for a period of 24 to 36 months; therefore, it is unlikely that its potential extension (if any) to UTPs will occur for two or three years.

However, we expect to see securitisation activity in the medium to long term as these shortfalls are overcome.

2.3.1. Securitisation Law amendments under 2019 Budget Law

Amendments to the securitisation framework under 2019 Budget Law might incentivise UTP securitisations

The development of a true-sale UTP securitisation market could benefit from recent amendments to the Securitisation Law[17], in the context of the 2019 Budget Law.

Following the envisaged implementation of the 2019 Budget Law[18], SPVs will no longer be prevented from advancing loans to micro enterprises, unless their balance sheets are smaller than EUR 2m. Furthermore, the law clarifies that an SPV may both advance loans and purchase receivables according to the traditional securitisation scheme, in the context of the same securitisation transaction (so-called mixed transactions). This amendment is of particular interest for the securitisation of UTPs, given the fact that these types of exposures require an active management approach (i.e. a going-concern approach).

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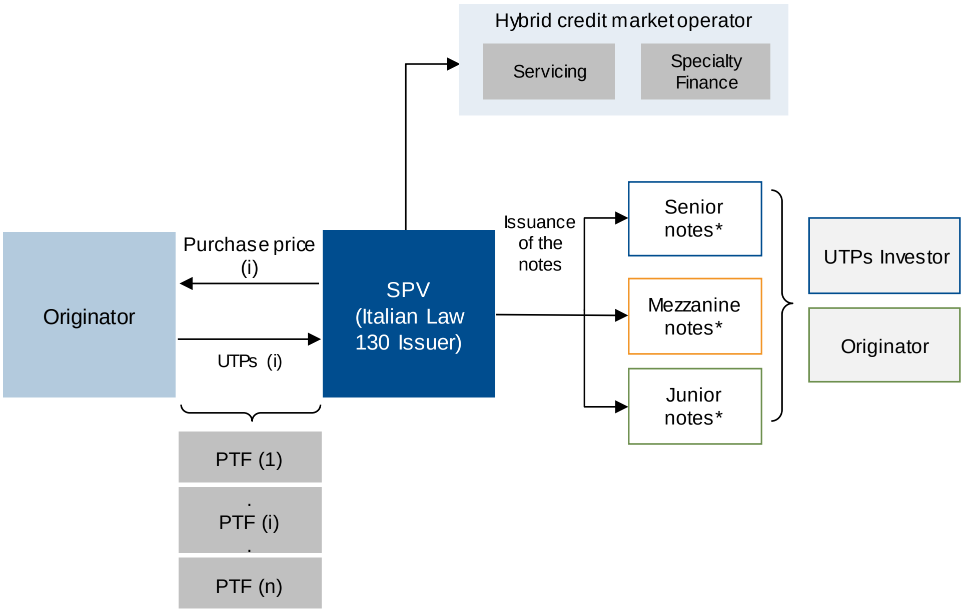
[15] In April 2018, Spaxs S.p.A. signed an agreement for a business combination with Banca Interprovinciale S.p.A.
[16] As envisaged in the D.L. n.22, Gazzetta Ufficiale n.71 of 25 March 2019..
[17] Law n. 130 dated 30 April 1999, as amended from time to time.
[18] Italian Law no. 145 dated 30 December 2018, commas 1088-1090.

The extension of the financing capabilities of SPVs to companies even smaller than traditional micro enterprises might facilitate securitisation of small and medium UTP exposures. SPVs will be able to invest in medium-term restructurings of small companies. The injection of fresh finance might contribute to a significant improvement in the financial conditions of businesses, which would ultimately result into a better amortisation profile of the notes.

UTPs securitisations might foresee ramp-up periods along with a revolving nature

UTP securitisations might adopt features that are more typical of performing transactions than NPL securitisations. In order to facilitate financing of enterprises by SPVs, UTP securitisations might emerge as a combination of a ramp-up period (in terms of maximum amount of issuance, within a specific period) and a revolving nature. This would allow vehicles to collect new liquidity from the additional issuance of notes and use part of a transaction's proceeds to grant loans to debtors in difficulties. This structure would be ultimately reflected in a securitisation's waterfall.

Figure 2 : Example of a UTP true sale securitisation



* Following the ramp-up structure

Sources: Scope Ratings analysis

2.4. Scope does not foresee synthetic securitisations

Synthetic securitisations would allow banks to maintain their relationships with debtors, with the adoption of a going concern approach[19]. In addition, banks would have a benefit in terms of capital relief[20].

However, the intrinsic structure of synthetic transactions (involving credit derivatives instruments like credit default swaps) would represent a challenge for UTP portfolios likely to go into a default status. First, the definition of credit events might be controversial for exposures with bad credit quality. Second, the high costs of credit derivatives would make the transactions economically unappealing for originators.

[19] Unlike true-sale securitisations, synthetic transactions do not require change of loan ownership but only the transfer of credit risk.
[20] Recent regulatory measures, such as calendar provisioning for NPLs ("Addendum to the ECB Guidance to banks on non-performing loans", Mar 2018), could incentivise banks to offload the extra-capital needs with a capital relief perspective.

2.5. Alternatives to direct UTP disposals and securitisations

2.5.1. Restructurings carried out by specialised investors

To manage corporate UTP borrowers, banks could liaise directly with specialised investors such as turnaround or vulture funds, without the involvement of servicers.

We expect that banks will manage part of their corporate exposures through investors specialised in corporate restructurings. In 2017, 76% of UTP exposures were related to corporates[21].

Alternatives to disposals and securitisations could foresee investors creating funds to acquire companies owning UTP exposures; and banks converting companies' debt into fund shares. Furthermore, even in case banks do not convert their UTP exposures into equity participations, they could establish strategic partnerships with investors to improve companies financial conditions. As part of these strategies and to achieve restructuring, investors opt for the injection of new finance, equity participations or debt underwriting. Following an investor action plan, banks can secure the repayment of their credit in the medium to long term while maintaining their commercial relationships with the borrowers.

2.5.2. Strategic partnerships between servicers and banks

As highlighted by recent market announcements[22], banks might establish strategic partnerships with servicers to improve management of UTPs exposures.

These partnerships would allow the adoption of different strategies for UTPs, based on loans' characteristics and on banks' economics. A portion of UTPs would be disposed if economically sound, whilst other exposures would be outsourced to servicers, remaining on banks' balance sheets. UTPs deconsolidation would occur depending on the specific agreements established between servicers and banks.

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[21] Bollettino Statistico Banca d'Italia II-2017. Data as of March 2017. Data refers to gross book values reported for the category "Societa' non finanziarie".

[22] Intesa Sanpaolo announced a potential strategic partnership with Prelios to improve UTPs management. EUR 1-2bn might be sold, whilst EUR 8-9bn might be outsourced to Prelios following their potential deconsolidation. Datasource: public data published on 27-mar-19.

I. Appendix – GACS eligible NPL Securitisations rated by Scope

Deal name/Link to Rating report	Issuance	Seller	Servicer (master and special)	GBV (million)	Scope rating Class A	Scope rating Class B	Coupon A/B
Elrond NPL 2017 Srl	Jul-17	Credito Valtellinese SpA, Credito Siciliano SpA	Cerved Credit Management SpA, Securitisation Services SpA	1,422	BBB-	B+	6mE+0.5%/ 6mE+6%
Bari NPL 2017 Srl	Dec-17	Banca Popolare di Bari Scpa, Cassa di Risparmio di Orvieto SpA	Prelios Credit Servicing SpA	345	BBB	B+	6mE+0.3%/ 6mE+6%
GBV of GACS eligible securitisations rated by Scope 2017 (EUR million)				**1,767**			
Siena NPL 2018 Srl	May-18	Monte dei Paschi di Siena SpA, MPS Capital Services Banca per le Imprese SpA, MPS Leasing & Factoring SpA	Juliet SpA, Italfondiario SpA, Credito Fondiario SpA, Prelios Credit Servicing SpA	24,070	BBB+	Not Rated	3mE+1.5%/ 3mE+8%
Aragorn NPL 2018 Srl	Jun-18	Credito Valtellinese SpA, Credito Siciliano SpA	Credito Fondiario SpA, Cerved Credit Management SpA	1,671	BBB-	B	6mE+0.5%/ 6mE+7%
Red Sea SPV Srl	Jun-18	Banco BPM SpA and Banca Popolare di Milano SpA	Prelios Credit Servicing SpA	5,097	BBB	Not Rated	6mE+0.6%/ 6mE+6%
4Mori Sardegna Srl	Jun-18	Banco di Sardegna SpA	Prelios Credit Servicing SpA	1,045	A-	BB-	6mE+0.9%/ 6mE+8%
2Worlds Srl	Jun-18	Banco di Desio e della Brianza SpA, Banca Popolare di Spoleto SpA	Cerved Credit Management SpA, Cerved Master Services SpA	1,002	BBB	B	6mE+0.4%/ 6mE+8%
BCC NPLS 2018 srl	Jul-18	21 co-operative banks co-ordinated by Iccrea SpA and two banks belonging to ICCREA Banca SpA	Prelios Credit Servicing SpA	1,046	BBB-	B+	6mE+0.4%/ 6mE+6%
Juno 1 Srl	Jul-18	Banca Nazionale del Lavoro SpA	Prelios Credit Servicing SpA	957	BBB+	Not Rated	6mE+0.6%/ 6mE+8%
Maggese Srl	Jul-18	Cassa di Risparmio di Asti SpA, Cassa di Risparmio di Biella e Vercelli-Biverbanca SpA	Prelios Credit Servicing SpA	697	BBB	Not Rated	6mE+0.5%/ 6mE+6%
Maior SPV Srl	Aug-18	Unione di Banche Italiane SpA and IW Bank SpA	Prelios Credit Servicing SpA	2,749	BBB	Not Rated	6mE+0.5%/ 6mE+6%
IBLA Srl	Sep-18	Banca Agricola Popolare di Ragusa ScpA	Italfondiario SpA	349	BBB	B	6mE+0.6%/ 6mE+8%
AQUI SPV Srl	Nov-18	BPER Banca SpA, Cassa di Risparmio di Saluzzo SpA and Cassa di Risparmio di Bra SpA	Prelios Credit Servicing SpA	2,082	BBB-	Not Rated	6mE+0.5%/ 6mE+7%
POP NPLS 2018 Srl	Nov-18	17 banks	Cerved Credit Management SpA, Cerved Master Services SpA	1,578	BBB	B	6mE+0.3%/ 6mE+6%
Riviera NPL Srl	Dec-18	Banca Carige SpA and Banca del Monte di Lucca SpA	Italfondiario SpA, Credito Fondiario SpA	964	BBB-	B+	6mE+0.65%/ 6mE+7%
BCC NPLS 2018-2 Srl	Dec-18	73 co-operative banks	Italfondiario SpA	2,004	BBB	B+	6mE+0.3%/ 6mE+6%
GBV of GACS eligible securitisations rated by Scope 2018 (EUR million)				**45,311**			
Leviticus SPV Srl	Feb-19	Banco BPM SpA	Credito Fondiario SpA	7,385	BBB	Not Rated	6mE+0.6%/ 6mE+8%
Juno 2 Srl	Feb-19	Banca Nazionale del Lavoro SpA	Prelios Credit Servicing SpA	968	BBB+	Not Rated	6mE+0.6%/ 6mE+8%
GBV of GACS eligible securitisations rated by Scope 2019 (EUR million)				**8,353**			

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