NPL Securitisations: Italy Continues to be the Main Market

During 2017 we saw public securitisations of non-performing loans (NPLs) in three of the four countries with an NPL ratio (the level of gross NPLs in relation to the total amount of outstanding loans) significantly above the EU average, namely Ireland, Italy and Portugal.

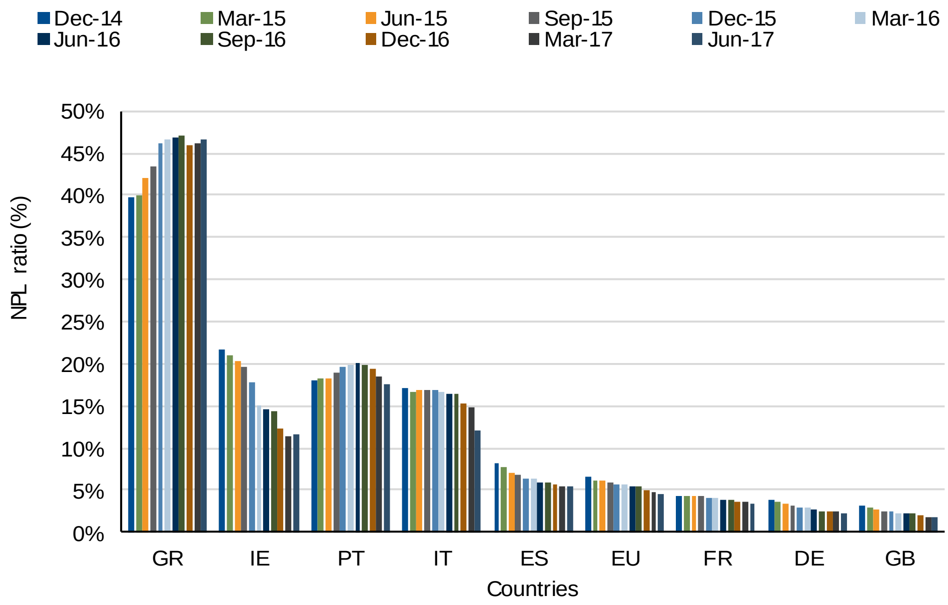
Given the robust GDP growth forecast and future trend for property prices in the countries where securitisations of NPLs have been done we expect the performance of these securitisations to be stable in 2018.

Specifically, for Italy we expect a sharp increase in GACS-eligible securitisations during 2018, reaching a volume in terms of gross book value of sold NPLs within the range of EUR 40-45bn, compared to around EUR 8bn done in 2017. Even if the transaction containing NPLs from Banca Monte dei Pasch di Siena would not close during 2018 as announced we still expect that the amount of GACS eligible securitisations during 2018 will be double compared to 2017.

NPLs and forborne exposures on banks' balance sheets are still high in some countries.

The level of gross NPLs[1] in relation to the total amount of outstanding loans (the NPL ratio) stood at around 5.1% in Europe at the end of 2016. It was therefore significantly higher than in the United States and Japan where the NPL ratio was around 1.5% by the end of 2016[2]. Most of the increase in the NPL ratio in Europe took place after the financial crisis in 2009 and, despite a general improvement since 2014, the ratio still remains quite high in a number of European countries, as illustrated in Figure 1.

Figure 1: Percentage of non-performing loans to total loan book (NPL ratio) for the EU as a whole and selected European countries from June 2014 – June 2017



Source: EBA Risk Dashboard Q2 2017[3]

Analysts

David Bergman
+49 30 27891-135
d.bergman@scoperatings.com

Investor outreach

Michael Pinkus
+49 30 27891 146
m.pinkus@scoperatings.com

Related research

2018 Structured Finance Outlook: Continent Cruising at Highs. Will Turbulence Hit Beyond 2018?
December 2017

Environment for Italian NPL Securitisation Continues to Improve
September 2017

Digital Challenge Looms Larger for European Banks (an Outlook for 2018 and Especially Beyond)
December 2017

Ten Reasons Why Italian Asset Quality Jitters May be Excessive
September 2017

Scope Ratings AG

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

[1] Following the financial crisis, various efforts have been made to agree on a single NPL definition in order to make it possible to compare banks and countries in a transparent way. In Europe, the European Banking Authority (EBA) introduced the technical standards applicable in Europe EBA FINAL draft Implementing Technical Standards On Supervisory reporting on forbearance and non-performing exposures under article 99(4) of Regulation (EU) No 575/2013. The data in this article is based on the EBA's definition of non-performing exposures which generally classifies all exposures that are more than 90 days in arrears as non-performing loans.

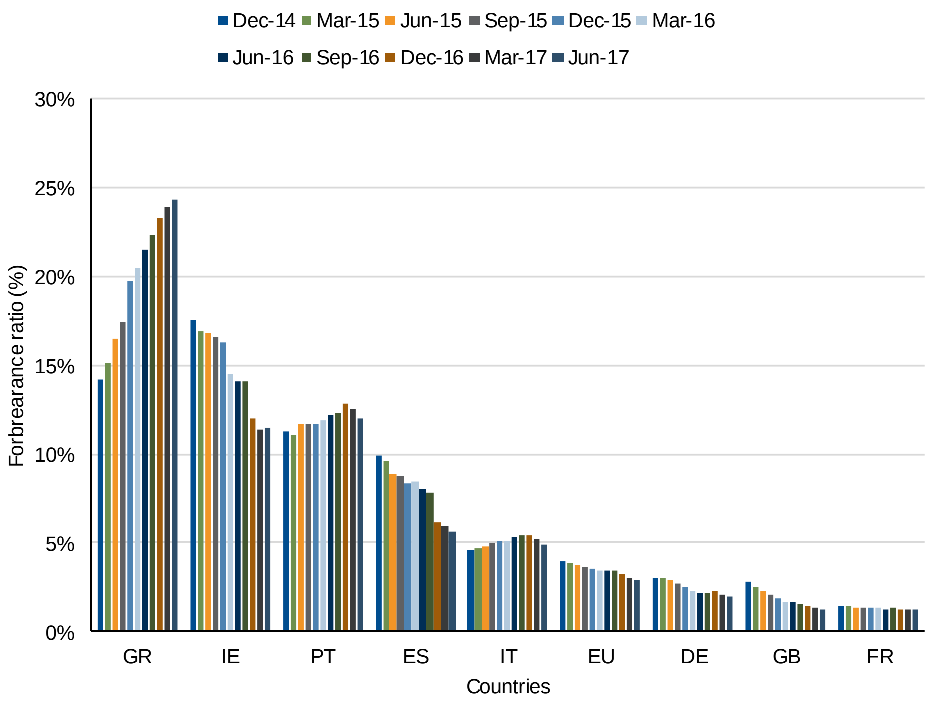
[2] ERSB, 'Resolving non-performing loans in Europe' July 2017

[3] http://www.eba.europa.eu/risk-analysis-and-data/risk-dashboard

Except for Italy countries with high amounts of NPLs also have large amounts of forborne exposures

In addition to NPL exposures, loans reported as forborne exposures (i.e. exposures that have been restructured and for which the borrower is at least partially performing) must also be considered in order to gain a more complete picture of the problematic loans in the banking system. As illustrated in Figure 2, most countries with high amounts of NPLs also have large amounts of forborne exposures, with the exception of Italy.

Figure 2: GDP growth rates for selected countries and EU average



Source: EBA Risk Dashboard Q2 2017[4]

In all of the countries mentioned in Figure 2, except for Spain, two thirds or more of the forborne exposures were reported as NPLs[5], i.e. the total of problematic exposures was significantly less than the sum of the forborne and NPL exposures. In Spain, slightly more than a third of the forborne exposures were reported as NPLs.

Securitisation of NPLs in Europe during 2017

2017 saw public securitisations of NPLs in three of the four countries with an NPL ratio significantly above the EU average, namely Ireland, Italy and Portugal.

GACS is the Italian government guarantee on payments of interest and principal on the senior note

In Ireland, the NPL ratio reported by the banking system had decreased significantly to around 11.7% in June 2017, down from 21.6% in December 2014. This was achieved by measures including the direct sale of portfolios of NPLs to investors. The subsequent securitisations of NPLs in Ireland were mainly undertaken by these investors in order to realise capital gains or optimise the capital structure of the acquired portfolios of NPLs.

In Italy, on the other hand, banks have used securitisation as a tool to move NPLs off their balance sheets by taking advantage of the government guarantee on payments of interest and principal on the senior note (the 'GACS'[6] guarantee). In Portugal Caixa

[4] http://www.eba.europa.eu/risk-analysis-and-data/risk-dashboard
[5] EBA Report on the Dynamics and Drivers of Non-Performing Exposures in the EU Banking Sector, July 2016
[6] Garanzia Cartolarizzazione Sofferenze, see Appendix I

Económica Montepio Geral used securitisation as a technique for offloading NPLs as an alternative to a portfolio sale.

In Spain, the banking system has mainly used portfolio sales of NPLs as a means of reducing the NPLs on its balance sheets. Spanish banks have restructured NPLs, transforming a relatively large proportion of them into forborne loans. This is reflected in the high forbearance ratio compared to the NPL ratio (Figures 2 and 1) and also the fact that, contrary to other countries, the majority of forborne exposures in Spain are not reported as NPLs. The securitisations undertaken by Spanish banks in 2017 therefore focussed on loans that had been forborne and were performing at the moment when the transaction closed (reperforming exposures) rather than NPLs.

Main advantages of a securitisation versus a portfolio sale of NPLs

A securitisation remove NPLs from the bank's balance sheet, rapidly

For most financial institutions seeking to rapidly[7] remove NPLs from their balance sheets, the choice is between making a portfolio sale, often on a bilateral basis, or a publicly distributed securitisation of NPLs.

The main advantage of a securitisation for the seller (i.e. the financial institution selling the NPLs) is that it can more easily attract different types of investor by tranching the underlying risk in different notes which also have a differentiated yield. As a consequence, the overall interest rate used to discount future cash flows is normally lower for a securitisation, which means that that the seller can obtain a higher transfer price for the NPLs, and thus reduce the potential loss between the book value and the sales price of the NPLs. For buyers of the junior notes, the increased leverage compared to a bilateral portfolio sale may improve their rates of return and, given the relatively small size of the notes, there is less need for funding compared to a portfolio purchase.

A portfolio sale has the main advantage that it can be completed more quickly as it merely involves the selection of single assets and a bilateral agreement on the data needed to value these assets. Another advantage is that the acquirer can by itself select the servicer for the NPLs.

Performance outlook

Given the robust GDP growth forecast and future trend for property prices, we expect that the performance of NPL securitisations will be stable in 2018.

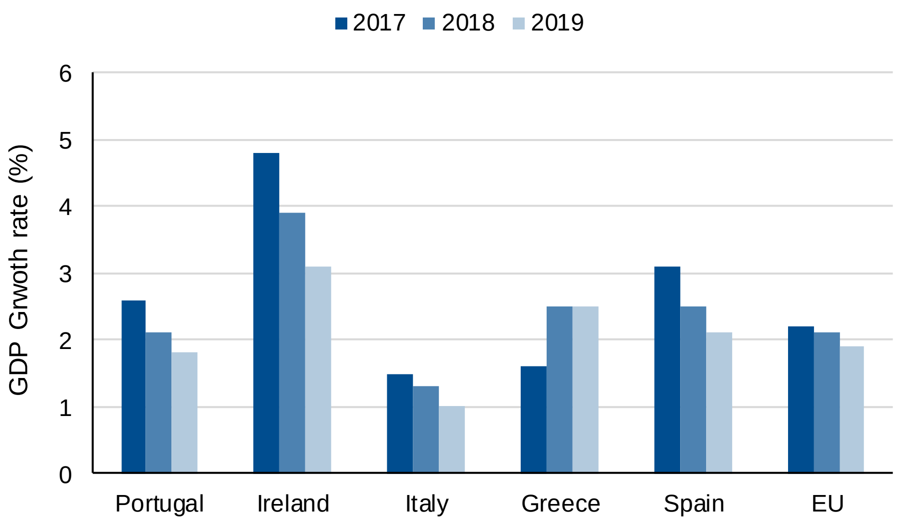
The general macro-economic climate and the development of property prices affects performance

The performance of NPL securitisations is heavily impacted both by the general macro-economic climate, as greater economic activity usually makes it easier to recover both unsecured and secured positions. In addition, the development of property prices, both residential and commercial, has a direct impact on recoveries as most of the secured loans in the NPL securitisations are backed by residential or commercial real estate.

As can be seen in Figure 3, the European Commission expects GDP growth rates for some of the countries with above-average NPL ratios to be higher than for the EU as a whole, with the exception of Italy. It should be noted, however, that Italy has not seen consecutive years of GDP growth rates in the 1-1.5% range for the last ten-year period.

[7] When time is less of a constraint, internal workout is also an option. State sponsored asset protection schemes or asset management companies have historically also been used in different European countries, but public capital and funding support to the banking sector in the EU is currently constrained by state aid rules and the BRRD. See also: 'Resolving non-performing loans in Europe' July 2017.

Figure 3: GDP growth rates for selected countries and EU average



Source: European Commission Autumn Forecast

Property prices in Ireland, Portugal and Spain already bottomed out more than a year ago and are currently increasing at various speeds. In Italy, property prices have not yet started to rise on a national level. The latest decreases have been small however, and the number of transactions has grown for both residential and commercial properties since the beginning of 2016, which indicates that prices have stabilised and could start to climb, albeit not very rapidly, in the coming years.

Issuance outlook

We expect Italy to remain the main European market for securitisations of NPLs in 2018

We expect Italy to remain the main European market for securitisations of NPLs in 2018, driven by: i) the need for Italian banks to further offload NPLs, as illustrated by the still-high NPL ratio; ii) the fact that the GACS guarantee has created a broader investor base for the senior notes and as well as making it possible for sellers to retain the senior notes and still achieve derecognition of the NPLs; iii) the prices of the GACS-eligible NPL securitisations which have been more attractive for sellers than portfolio sales, allowing them to reduce losses or the need for extra provisioning when selling the NPLs; iv) the third-party servicing market in Italy which is well established and can handle more securitisations of NPLs; v) improved seller ability to collect and present the data necessary to analyse underlying assets due to increased reporting requirements for NPLs to Bank of Italy together with the experience drawn from the initial securitisations; and vi) the comparatively low forbearance ratio which makes NPLs the main assets to securitise rather than reperforming loans.

Sharp increase in GACS-eligible securitisations in Italy in 2018

For the abovementioned reasons, we expect a sharp increase in GACS-eligible securitisations in Italy in 2018, reaching a volume in terms of gross book value of sold NPLs within the range of EUR 40-45bn, compared to around EUR 8bn in 2017. This forecast is however sensitive to the announced transaction containing NPLs from Banca Monte dei Paschi di Siena because if it does not go ahead the forecast may drop down to around EUR 13–18bn in gross book value, which in any case is significantly more than what has been done in 2017.

As the, albeit short, history of these transactions has shown performance to be more or less in line with expectations, investors' appetite is also expected to grow, which will make the secondary market more liquid compared to 2017.

It is also possible that, if the market becomes liquid enough, some of the investors who purchased portfolios of NPLs directly from a bank will issue a subsequent securitisation in order to make a profit or optimise the capital structure, with or without the GACS guarantee on the senior notes. The advantage which the secondary seller has (compared to the point at which the portfolio was originally purchased from the banking system) is that it has had more time to formulate a strategy for each exposure and also to clean the data, thus facilitating the data collection and presentation phase of a securitisation. Should this come to pass, the total amount of NPL securitisations will exceed the EUR 40-45bn range indicated above.

Ireland and Portugal, similar number of securitisations in 2018 as in 2017

Although Ireland and Portugal are significantly smaller than Italy, we nevertheless expect them to see a similar number of securitisations in 2018 as in 2017. We also expect securitisations in Spain to continue to focus on reperforming loans and the offloading of NPLs through portfolio sales.

Of the countries with a high NPL ratio indicated in Figure 1, Greece is the only country which has not seen any public securitisations of NPLs so far. If the availability of experienced special servicers improves, the first securitisations will be undertaken in 2018.

Appendix I Garanzia Cartolarizzazione Sofferenze (GACS guarantee) overview

Italian sponsors of NPL securitisations can ask the Italian Ministry of the Economy and Finance to guarantee the interest and principal payments on the senior notes. The guarantee is provided directly to the investors holding the senior notes, while the special purpose vehicle issuing the notes (the issuer) must pay the cost for the GACS guarantee with priority over interest on the most senior notes.

The cost of the GACS guarantee is calculated based on a basket of credit default swaps (CDS) made up of Italian reference entities. The rating on the senior notes (which does not consider the guarantee as it is provided directly to the investor) impacts the cost of the GACS guarantee by affecting the selection of the entities included in the basket of CDS in the following way:

1. If the rating assigned to the senior note is BBB+, the reference entities included in the basket are rated A-, BBB+ and BBB
2. If the rating assigned to the senior note is BBB, the reference entities included in the basket are rated BBB+, BBB and BBB-
3. If the rating assigned to the senior note is BBB-, the reference entities included in the basket are rated BBB, BBB- and BB+

The annual fee paid for the GACS guarantee over the first three years is equal to the three-year CDS premium for the basket, while in years four and five, the costs increase to the five-year CDS premium for the basket plus an additional spread. In years six and seven, the seven-year CDS premium plus a spread is applied, while from year eight and onward the cost is equal to the seven-year CDS premium without the application of any additional spread.

How is the guarantee activated and what does it cover?

The GACS guarantee can be enforced by the senior noteholders in the event that the issuer does not pay the interest, in full or in part, due on any payment date.

If the issuer has not paid the full amount of interest on the senior notes within 60 days following the payment date, the representative of the noteholders sends, on behalf of the senior noteholders, a request to the issuer to immediately pay the difference and accrued interest. If the issuer has not paid within 30 days following the receipt of this request, the representative of the noteholders can activate the GACS guarantee. Within 30 days of having received the request from the senior noteholders (from their representative) the Italian Ministry of the Economy and Finance will pay the relevant amount of interest to the senior noteholders.

Given the pass-through nature of the notes, the principal is only considered to be due at the final legal maturity date. Therefore, any senior noteholder requests to be reimbursed for unpaid principal amounts can only be activated after the final legal maturity date of the notes.

Scope Ratings AG

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris
33 rue La Fayette
F-75009 Paris

Phone +33 1 82 88 55 57

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com