Public Securitisations of Italian NPLs Make an Unsteady Comeback in 2017

Scope anticipates that public securitisations of Italian non-performing loan (NPL) ABS will slowly resurface in 2017, as their return can help improve Italian banks' balance sheets, which will allow banks to refocus on retail and corporate lending. How quickly this asset class expands in 2107 will depend on both additional GDP growth and government initiatives. If positive, both factors will encourage investors to revise expectations on NPL recovery timing and amounts, helping to close the bid-offer gap on Italian NPL portfolios. This report shows how the large NPL build-up among Italian banks and the level of historical recoveries are linked to GDP growth: recovery rates are unlikely to improve significantly until the Italian economy grows faster than the currently dismal 0.7% in 2016 and the 0.9% expected for 2017.

The securitisation of Italian NPL portfolios will be slow and likely limited to a few deals, which are also expected to be delayed until the second half of 2017, when the Italian government initiates further actions to support NPL ABS. In the meantime, private sales of NPL portfolios to private-equity-type investors will continue, and we even anticipate a slight increase (up from the EUR 20bn by gross book value in 2015 and in 2016 YTD up to October). We expect that better-performing banks will be able to absorb write-offs required to meet foreign investors' bidding prices, and use tax incentives introduced by the previous government to encourage disposals of NPL portfolios. Foreign private-equity investors will continue to be drawn to the potentially high returns on NPL portfolios.

Scope expects the Italian government to continue to support the development of NPL ABS, as a way to improve liquidity and market transparency, and to reduce the large stock of NPLs among Italian banks. Currently, outright sales of NPL portfolios to individual private-equity investors are depriving the market of valuable information on prices, recoveries, and servicer performance. The lack of a well-established market is also helping to maintain a liquidity premium, which can result in heavily discounted transfer prices for banks upon the sale and larger write-off of NPLs.

The government's recent initiatives will only bear fruit once investors can see solid improvements in recovery levels and timing. Government initiatives aimed at shortening the time required to enforce collateral, thereby improving the time and amount of recoveries, are credit-positive.[1] However, the recent guarantee scheme for senior NPL ABS tranches is not enough to close the bid-ask gap, given investors of this asset class comprise private-equity funds targeting double-digit returns.

Scope believes Italian NPL ABS are back for good in 2017. As we will discuss below, the Italian government will need a more systemic approach to reduce NPLs on banks' balance sheets and jump-start the NPL ABS market. One way is to develop a state-sponsored platform or asset management company to purchase NPLs from troubled banks at, or close to, market prices. Such a solution would still require private-sector banks to take write-offs and force junior bondholders to be bailed in, as per EU rules, before accepting government money to recapitalise. A state-sponsored vehicle could securitise NPLs over time to avoid an oversupply of NPL ABS and to provide the market with frequent and transparent information on transfer prices, recoveries, and servicer performance. Such a vehicle could also repackage NPLs into secured and unsecured portfolios, thereby targeting different investors and improving liquidity.

[1] Italy moves forward on loan loss deductibility, insolvency reforms, July 2015.

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Last recession and currently low growth drive Italian NPL overhang

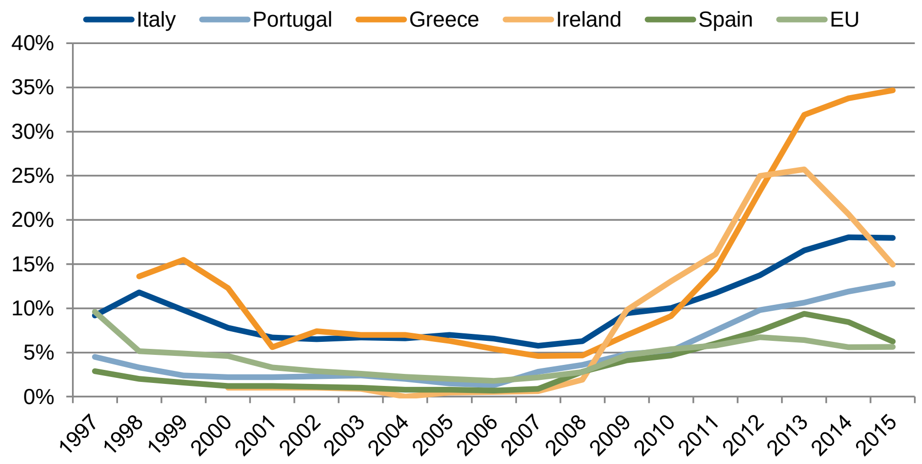
The stock of Italian NPLs remains very large, in spite of a decline in the first half of 2016. In Italy, like in other peripheral European countries, the crisis has had a profound impact on the build-up of NPLs (also exacerbated by bank-specific factors), and the prolonged recession has led to higher default risks in corporate loans.

In the first six months of 2016, according to Bank of Italy, the stock of Italian gross NPLs fell by EUR 4bn to EUR 356bn. The reduction was more pronounced net of provisions, falling by EUR 6bn to EUR 191bn. In June 2016, the ratio of NPLs gross of provisions to total customer loans was 17.7, about 0.4 percentage points lower than in December 2015.

The stock of Italian NPLs represents a much higher percentage of total loans than in other eurozone countries

The stock of Italian NPLs represents a much higher percentage of total loans than in other eurozone countries and against the eurozone average (see Figure 1), below only those of Greece and Cyprus but above the percentage in countries such as Ireland and Spain, which have taken a systemic approach to the NPL problem.

Figure 1: Banks' NPLs to total gross loans ratio in select eurozone countries



Source: Data World Bank.org

Unlike other countries, where NPLs are concentrated in the real estate sector, assessing the value of Italian NPL portfolios is a challenge because portfolios are very heterogeneous, and mostly relate to commercial loans, which include a large number of micro and small enterprise. The concentration of non-performing obligors in the corporate sector requires specialised servicing. According to the Bank of Italy, 78.86% of non-performing loans are related to the corporate sector.[2]

Italian NPL performance sensitive to legal recovery and GDP growth

Based on the performance reports of NPL portfolios securitised in the 1999-2003, past cumulative recovery rates have averaged after 72 months since closing to just over 60% for secured loans and just over 20% for the unsecured. Two main factors impact the amount and the timing of recoveries: Firstly, the Italian judiciary is overburdened and the courts lack specialisation. Recoveries through the courts can take 7-10 years in certain regions. The length of time it takes to recover directly affects the net recovery amount as legal expenses, and administrative and funding costs continue to accumulate during the recovery process. And secondly, GDP growth affects the performance of SMEs (the largest class of obligors) and property prices, and thus has a direct impact on NPL recovery rates.

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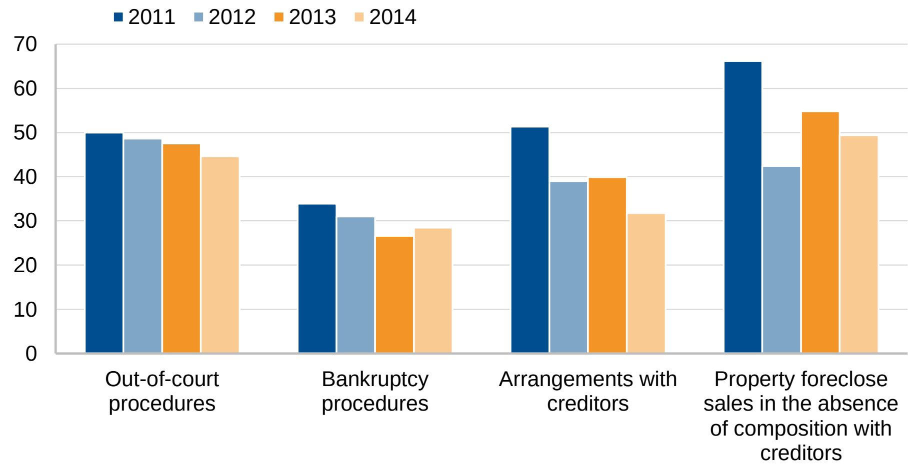
[2] Source: Bank of Italy, Financial Stability Report No.1 2016.

Recovery rates for various types of recovery strategies (out-of-court settlements, bankruptcy proceedings, arrangement with creditors, and foreclosures) steadily declined from 2011 to 2014, during which Italy's GDP barely grew. Figure 2 and Figure 3 show the economic cycle's impact on recovery rates for NPL portfolios.

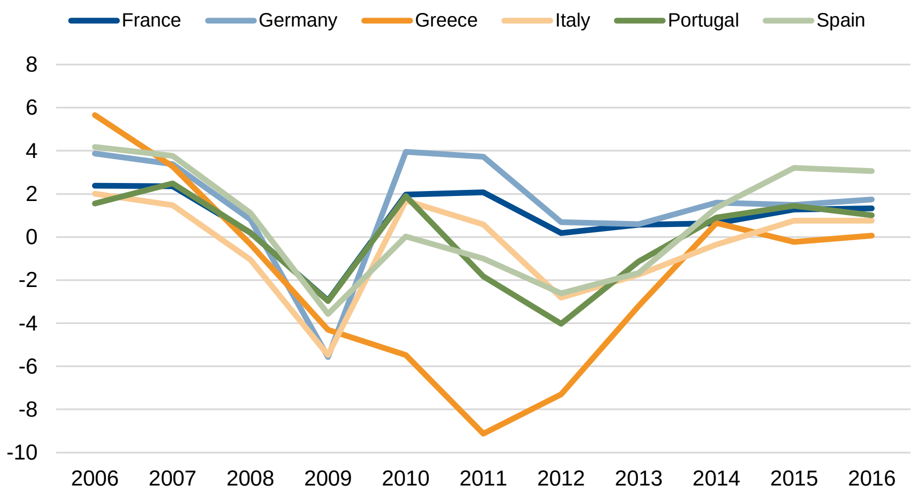
Recovery rates steadily declined from 2011 to 2014

Figure 2: Overall recovery rates of procedures closed in 2011-2014



Source: Bank of Italy Financial Stability Report No.1 2016

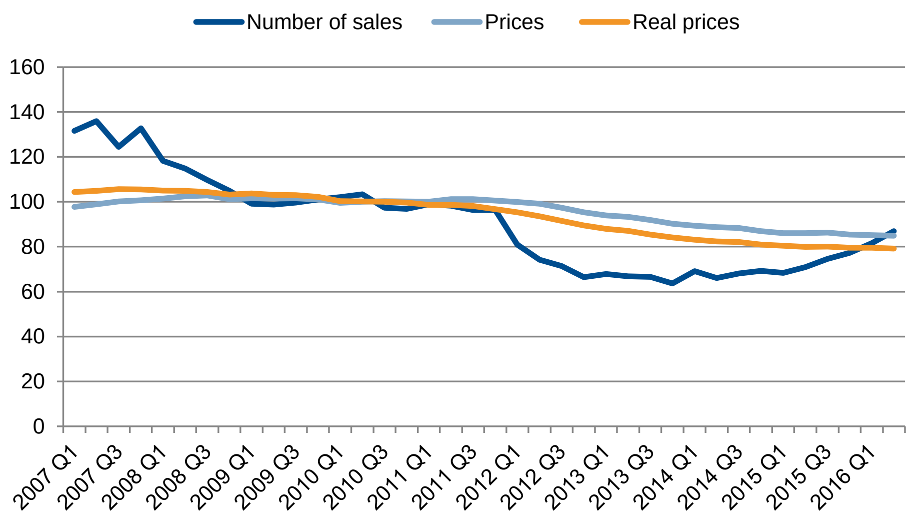
Figure 3: GDP growth rates in selected eurozone countries



Source: International Monetary Fund, World Economic Outlook Database, October 2016

Trends in real estate prices directly impact recoveries on secured NPL portfolios. This partly explains why recovery rates for NPL portfolios declined during the same years. Figure 4 shows that during 2011-2014 Italian residential real estate prices were in a clear downward trend due to the recession and liquidity issues (as measured by number of transactions that drastically declined).

Figure 4: Italian residential property price indices 2010=100



Source: Bank of Italy Financial Stability Report No. 2 2016

Growth in NPL portfolio securitisation faces obstacles

In the past few years there were several sales of portfolios, estimated at EUR 20bn by gross book value each in 2015 and by October 2016 according to Banca IFIS. 2016 saw the first public securitisation in many years.

The substantial gap between bid-ask prices and persistent lack of economic growth limits NPL securitisations

Some factors, however, are preventing a much larger number and size of disposals and/or securitisations of NPL portfolios. These include: i) a still wide gap between bid and ask prices, particularly for the portion of portfolios secured by real estate; ii) the continuing lack of growth in the economy and consequent expectations of low price appreciation in real estate; and iii) portfolios for sale that very often comprise a mix of secured and unsecured loans, making them less attractive to investors interested in secured loans rather than unsecured, or vice versa.

Most importantly, a wide gap between bid and ask prices persists, particularly for the portion of portfolios secured by real estate, due to banks' reluctance to take additional write-offs. The gap is also widened by accounting rules. International accounting principles require banks to accrue in their annual accounts the indirect costs of managing NPLs (legal expenses, administrative costs, etc.); whereas potential purchasers can deduct them immediately from the actual value of the bad debt, consequently reducing the purchase price. Also, to comply with IAS/IFRS accounting principles, banks must discount future cash flows with the assets' original effective interest rate; investors, on the other hand, can use the investment's expected return, which in the case of private-equity funds is presumably a significantly higher value. The gap is also driven by NPL investors demanding a high rate of return; partly because they generally have less financial leverage than banks, and partly due to a lack of liquidity in the NPL market, which causes investors to add a liquidity premium.

Italian government helps in tackling the NPL problem

Public securitisations support market transparency

The Italian government has encouraged the securitisation of NPL portfolios, not only to clean up the banks' balance sheets, but also as a way to improve the liquidity of NPL portfolios, reducing in part the risk premium required by foreign investors. Public securitisations contribute to transparency both in loan valuations and the comparisons between the performances of asset managers/special servicers. Public securitisations and a more liquid market can attract traditional institutional investors, reducing the reliance on private-equity funds.

The Italian government has taken steps to reduce NPL recovery times, increasing incentives for banks to sell or securitise NPL portfolios and jump-starting a more liquid NPL ABS market. The government's actions will start bearing positive results in the next few years as recovery rates will reflect the impact.

The Italian government has taken steps to reduce NPL recovery times

The main initiatives taken by the previous government in the NPL sector are as follows:

1. A new guarantee scheme for the securitisation of NPLs (Garanzia Cartolarizzazione Sofferenze or GACS), which aims to increase liquidity in the market by facilitating leverage on portfolio sales. In a nutshell, GACS is a provision for a government guarantee on senior notes issued by an Italian SPVs.

   The guarantee applies when the notes are backed by NPL assets and i) are serviced by external servicers independent of the originating bank; ii) the originator has sold at least 51% of junior and mezzanine notes; iii) senior notes are rated investment grade; and iv) the guarantee premium is a senior cost in the waterfall and is at market rate (based on the average price of a basket of single name CDSs covering investment-grade-rated Italian companies, at the same duration as the notes).

   The guarantee covers interest and principal payments due on the amount outstanding on the senior notes at their legal final maturity date. Payments will be made between four and nine months from the point at which the noteholders' representative requests payment.

2. New laws to address legal issues related to credit recovery, legal and technical solutions. The new laws are credit-positive. It will take time, however, before their impact will materially affect the average time to foreclosure and thus be incorporated in investors' pricing models.
3. The immediate tax deductibility of write-offs within a year instead of five years (from August 2015).
4. The set-up of two funds (Atlante 1 and 2) to contribute capital to troubled banks and to buy mezzanine and junior tranches of upcoming securitisations. The government has been instrumental in their set-up, but without making direct equity contributions.

Italian NPL ABS market is back, but needs additional support

Public securitisations of Italian NPLs portfolios were frequent between 1999 and 2003, before almost completely disappearing from 2004. During 1999-2003, the government allowed banks to deduct losses from write-offs over five years instead of the usual 18. This temporary tax provision incentivised banks to sell or securitise non-performing loans. But during the last recession, investor interest in this asset class, and other less-traditional types, disappeared and this tax incentive was removed.

First results from the guarantee scheme has been mixed. A more systemic approach to reducing NPL stocks might include the creation of a state-sponsored securitisation platform

The first result from the guarantee scheme has been mixed at best. To date, only Banca Popolare di Bari has issued a EUR 150m securitisation, in the second half of 2016. The bank retained the senior tranche, funded via a repo with a major international bank. Also, the bank had to offer a significant discount to sell the most junior tranche to investors, a condition under the government's guarantee. This discount indicates that the guarantee scheme still had not managed to bridge the gap between investors' and sellers' valuations of Italian NPL portfolios.

The Atlante funds have committed to purchase at par the mezzanine tranches of a large securitisation from Monte Paschi di Siena; but this is currently on hold following the recent partial nationalisation of the bank. This securitisation is expected to amount to EUR 9.1bn and to be backed by EUR 27.6bn of non-performing loans. However, this transaction once it resumes would become the benchmark for the market. Portfolio managers of the Atlante funds have indicated that they are targeting returns in the upper single digits, well below the 18-22% generally sought by private-equity funds. The Atlante funds, however, have limited resources and can only absorb the mezzanine and junior tranches of a few NPL ABSs. Once the Atlante 1 and 2 funds have been fully deployed, banks will have to pursue alternative solutions to reduce NPLs on their books. As a result we expect that more mezzanine and junior tranches will be sold in the market, possibly at a discount to attract private-equity funds. Alternatively NPL portfolios may be transferred to securitisation vehicles. In order to attract investors, price transfers could also happen at lower prices than the already low 30% of gross book value achieved by Banca Popolare di Bari.

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