COVER STORY European debt sale

PRIME DESTINATION

Whilst Italy is gaining momentum as Europe's most active non-performing loan market, the UK is coming close to shedding the last of its financial crisis debt. AMBER-AINSLEY PRITCHARD takes a look at the most talked-up markets past and present

Having grown from zero to market leader in three years, Italy is experiencing a strong evolution in the transaction of non-performing loan (NPL) portfolios.

It was the most active market for NPL sales in Europe last year with €36bn of deals completed. Bets are on for Italy to outdo its performance this year with an estimated total of €53.3bn of deals to be completed by the end of 2017.

According to some of the UK's big four accountancy firms Italy will end the year with the title of most active market for distressed debt in Europe.

Italy has the highest overall NPL ratio of the big five European economies, at 15 percent, according to data from the European Banking Authority which found Italy's largest banks still have €271bn of NPLs outstanding.

As for the rest of Europe's performance, experts said the year started off slowly. A report from Deloitte, *Shifting Momentum*, found that during the first six months of 2017, €42bn of deals had been completed with an estimated €86.5bn of deals ongoing.

Luca Olivieri, head of Italy at Deloitte, challenged the opinion the market has been slow moving, claiming it is running at full capacity. He said it should be remembered that only so much equity is available to carry out deals and currently there isn't enough capacity to absorb multiple jumbo deals.

Italy is forecast to complete the most deals this year, with €9.3bn of sales completed and €44bn of deals ongoing. This means Italy contributes to more than 50 percent of Europe's total ongoing transactions.

Even though Italy is set to be 2017's top performer, the UK has already completed €20.2bn of sales for the first half of this year. Experts have said the UK is in the final phase of its post-crisis deleveraging journey and sold most of its significant non-performing holdings.

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> **Vito Ruscigno**
> Co-head of NPLs and distressed assets
> PwC Italy

Two journeys

Comparing how the UK has managed its financial crisis debt with Italy's volume of NPLs from the same period, it seems Italy might only be half way through that journey.

Deloitte's report shows that Italy has grown its NPL activity from €3.7bn of completed deals in 2014 to €36bn in 2016. If the figure of Italy's ongoing deals are completed this year, the country will end 2017 with €52.8bn of loan portfolios sold. This would be an increase of around 1,400 percent between 2014 and 2017.

The top seller in Italy during the first half of 2017 was Intesa (€2.1bn), followed by Banco BPM (€1.3bn), Banca Nazionale del Lavoro (€1bn), and Deutsche Bank (€0.6bn).

All these figures include a mixture of consumer, residential and commercial asset types.

The largest portfolios sold in Italy still contain a mixture of asset types, with

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consumer and commercial placed in them.

However, Deloitte does show some slightly more granular information, showing that about €8.6bn of consumer portfolios were sold in 2016, with an estimated total of €4.3bn to be sold in 2017.

As for the UK, Deloitte says the number of NPL sales have fluctuated between 2014 and 2017. In 2014, UK creditors sold €27.6bn of portfolios which jumped to €40.3bn in 2015 before beginning to decline in 2016 - to €13bn. These figures include residential, consumer and commercial property portfolios.

The same report shows that £8.6bn of consumer portfolios were sold in 2016.

Deloitte's figures for sales so far in 2017 only include residential portfolios. The accountancy firm has calculated that €20.2bn of these have been sold so far, with an estimated €300m of transactions ongoing. The £20.2bn was almost entirely accounted for through one deal; a £19bn sale of mortgage books of Bradford & Bingley and Northern Rock, sold by UK Asset Resolution to Prudential Capital and Blackstone.

Olivieri said the asset type that is moving at the greatest volume and speed in Italy is SME debt, which makes up 70 percent of Italy's NPL stock.

So will Italy overtake the UK in the value of deals in future? Experts from the big four accountancy firms believe so. Olivieri said the UK is becoming second tier and it isn't really a country of investors' focus.

Regulatory influence

It's no wonder some experts think the Italian market has had a slow start, with the sluggish regulatory intervention that could otherwise have impacted deal making earlier. NPL sellers are now dealing with the European Central Bank's (ECB) new guidelines on NPL recognition and disposal strategy.

These guidelines call on banks to implement realistic and ambitious strategies to work towards a holistic approach regarding their NPL problems. This includes areas such as governance and risk management. For instance, banks should ensure managers are systemically incentivised to carry out NPL reduction strategies.

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> **Head of Italy, Deloitte**

The ECB does not stipulate quantitative targets to reduce NPLs. Instead, it asks banks to devise a strategy that could include a range of policy options such as NPL work-out, servicing, and portfolio sales.

Vito Ruscigno, co-head of NPLs and distressed assets at PwC Italy, said these guidelines mean Italian banks will be forced to find a solution to their huge amount of stock.

These guidelines and the forthcoming adoption of IFRS 9 standards, which will push banks towards a more forward-looking and rigorous approach to loss provision, have created a heavy workload for banks.

They have had to hire new staff and create new divisions to identify NPLs in considerable granular detail, and to report back to the ECB on exposures and disposal strategies. Deloitte said that in some cases, banks have simply been too busy to sell.

As well as this, the European Banking Authority's (EBA) latest transparency exercise for 2017, which draws data from all significant eurozone banks on current NPL exposure, estimated there are more than €1trn of NPLs still on banks' books in the eurozone.

The transparency exercise is part of efforts made by the EBA, which supervises prudential regulation, to foster market discipline, improve the understanding of the EU banking system and ensures both a detailed snap shot and consistent series of reports on NPL exposures.

Deloitte estimates this figure could in fact be double when non-eurozone and non-core assets are included, with a total of €2trn in European loans that could come to market.

As for specific Italian legislation, the government has adopted measures to promote new financing to Italian companies. It has also broadened the range of entities allowed to provide credit in Italy which were traditionally limited to banks and financial intermediaries.

More specifically, since 2014, collective investment schemes have been allowed to provide financing, including indirect lending, through the purchase of existing receivables. The recent reforms aim to facilitate the creation of a shadow banking system to supplement the traditional sources of credit.

The ECB also published a financial stability review in May 2017 which contained various proposals designed to support NPL securitisation and true sale markets using the provision of state-supported funding as a tool to enhance pricing.

A persistent theme of the review is the ECB's view of a cross-country market failure to deal comprehensively with NPLs. The review reflects that "a comprehensive range of policy options may have to be pursued to tackle large stocks of NPLs and to address the attendant market failures."

However, Deloitte's report does show that record levels of NPL and non-core assets are being sold, with countries like Italy having gone from zero to a market-leading position over the last three years.

Deloitte believes it will take five or more years of bank restructuring and risk reduction before the demands of regulators and the capital resources of banks reach a point of equilibrium.

Yet Olivieri believes the Italian government cannot directly intervene with its protocols and regulation to help accelerate the speed and number of deals taking place in Italy.

"The only intervention the government can effectively have right now, is to try and persuade banks to merge, sell, or put in place the right litigation to make sure there is additional help to allow banks to more effectively sell NPLs. Direct intervention from the government is not possible. We have no public banks or public funds for investing in NPLs, so it's not really as active as it possibly was a few years ago."

Another aspect of the regulatory environment that is frequently debated by servicers and investors, is the litigation process. Industry professionals have previously bemoaned the process as being very slow in Italy - but there are signs this could be changing.

In 2015, the Italian government intervened with a package of measures which aimed to shorten the duration of failures, increase the success of the courts, and speed up the implementation of procedures on movable and immovable properties.

Link Financial Outsourcing said the impacts of those measures, according to a small group of banks and market participants, could be significant. They estimate that these rules have led to a significant reduction of the length of the litigation process.

Servicing space

PwC said the NPL servicing space in Italy is experiencing a strong evolution. In its report, *The Italian NPL Market: The Place to Be*, published in June 2017, it said the role of independent specialised NPL servicers is gaining importance. PwC said this is driven by an increased volume of portfolio disposals from banks to investors, together with growing outsourcing of recovery activities by banks driven by lack of capacity, and fostered by the implementation of ECB guidelines.

Because of this, the accountancy firm said the market is experiencing a growing number of M&A transactions as well as the establishment of new important players.

Experts added that additional growth opportunities may be connected with recovery activities of the unlikely-to-pay segment and of the performing loans.

EY said that managing NPLs through in-house departments could increase recovery rates and operational efficiency. It said some banking groups have set up internal specialised departments, with integrated ad-hoc software systems to digitalise the management of recovery procedures and act as historical data repositories.

Compared to the UK, the regulatory regime for debt servicing in Italy is very different; NPL market operators are subject to legislative and regulatory framework of varying degrees from different authorities.

In Italy, there is no individual regulator with total authority that can fine, intervene and close down companies as is the case with the Financial Conduct Authority (FCA).

Donato Pinto, managing director of Link Italy, said: "The Italian regulators do have the power to take action against organisations which contravene the rules, which encompass the treatment of personal data and reporting requirements.

"One difference to the UK, for example, is that there is not currently a requirement to assess customer affordability before you accept a repayment plan."

Link Financial Outsourcing explained that, in Italy, NPL special servicers and debt collection companies must obtain a licence for public security granted by the interior minister, to prove that certain mandatory requirements are met and maintained.

PwC said the Italian servicing market is one of the most important and performing in Europe. Ruscigno said: "Considering the huge stock which will be deployed from banks to the market through sales or outsourcing, the actual servicing capacity is lower than the demand. Consequently, who invests in capacity can increase market share and connected revenues."

Expert eyes

Going forward, Italy is viewed as the key player in the European market. Richard Thompson, global leader of PwC's Portfolio Advisory Group, said Italy is top of the table for NPL exposure. He said investors' interest moves with the market, and the high interest in Italy remains.

Describing the market as gaining momentum, Deloitte believes pricing in Italy has become more realistic over the last 18 months, and as a result deals are being done faster. Investors have become more confident

SECURITISATION IS BACK

Following the introduction of the Guarantee on Securitisation of Bank NPLs (GACS) scheme in 2016, from the Italian government, a resurgence of NPL securitisation is expected.

The scheme introduces rules envisaging a guarantee mechanism to be used to facilitate the removal of NPLs from the books of commercial banks.

EY said banks will have the option to offload their NPLs to a special purpose vehicle that will finance the acquisition through a junior tranche, with no guarantee, and a senior tranche for which a government guarantee can be bought, with the only condition that senior notes should be rated as investment grade.

To avoid the guarantee being considered as government aid, the price paid for it by the special purpose vehicle will be determined on the basis of a basket of credit default swaps on Italian issuers with similar risk profiles.

EY believes this scheme will increase investor appetite toward the Italian NPL market, reduce the bid-ask pricing gap and increase liquidity.

in the potential return from recovery processes, recovery strategies have become more efficient, and sellers are achieving higher prices.

As for the UK, Deloitte said the market has begun to recover from the pause induced by the Brexit vote in mid-2016; investors are taking a business-as-usual approach to deal making, against a background of confidence in the creditor-friendly legal environment, established and predictable deal processes, and the quality of returns on investment.

On a wider landscape, experts believe the European NPL market functions well but are still observing that current barriers are the most significant and fundamental ones. Insufficient capital in many parts of the sector and, on a more focussed basis, the effectiveness of the legal framework and problematic real estate markets in certain countries. However, it said the combination of the NPL Guidance and IFRS 9 should help to support further capacity-building but further work must be done by governments to remove the remaining obstacles to recovery optimisation.

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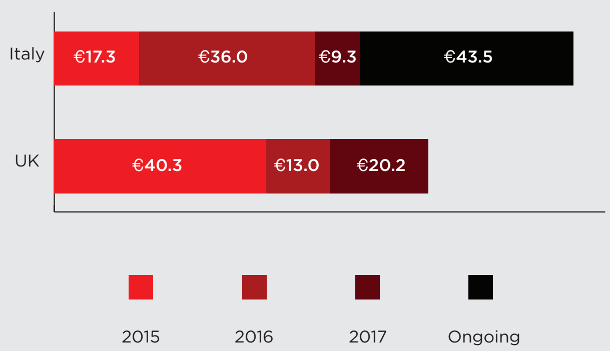
> **Deloitte**
> **Shifting Momentum report**

Deloitte added: “We are 10 years into the crisis but, against this backdrop, it remains in the balance as to whether we are only half way through resolving this issue.”

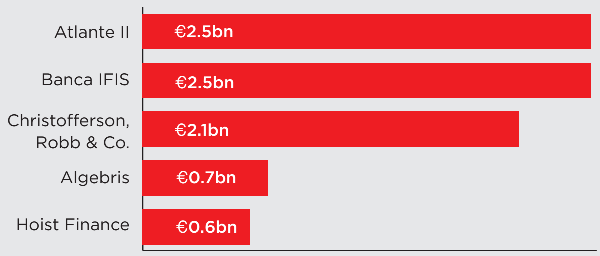
During *Credit Strategy’s* Credit Week, a dedicated conference on the European NPL market will take place on March 14 2018: CDSP European NPL. CS

DEBT SALE ACTIVITY

Activity by country (€bn)



Italy top buyers in the first half of 2017



Source: *Deloitte; Shifting Momentum report*