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Italian non-performing loans

State guarantee and securitisation scheme … Unlocking the NPL log-jam?

OVERVIEW

The Italian government has recently found an agreement with the European Commission to introduce rules aiming at reducing the NPLs stock from the books of Italian commercial banks. The scheme envisages State guarantees as part of securitisations transactions having NPLs as underlying assets.

The European Commission has agreed that the proposed structure does not constitute State aid as the guarantee will be priced at market level.

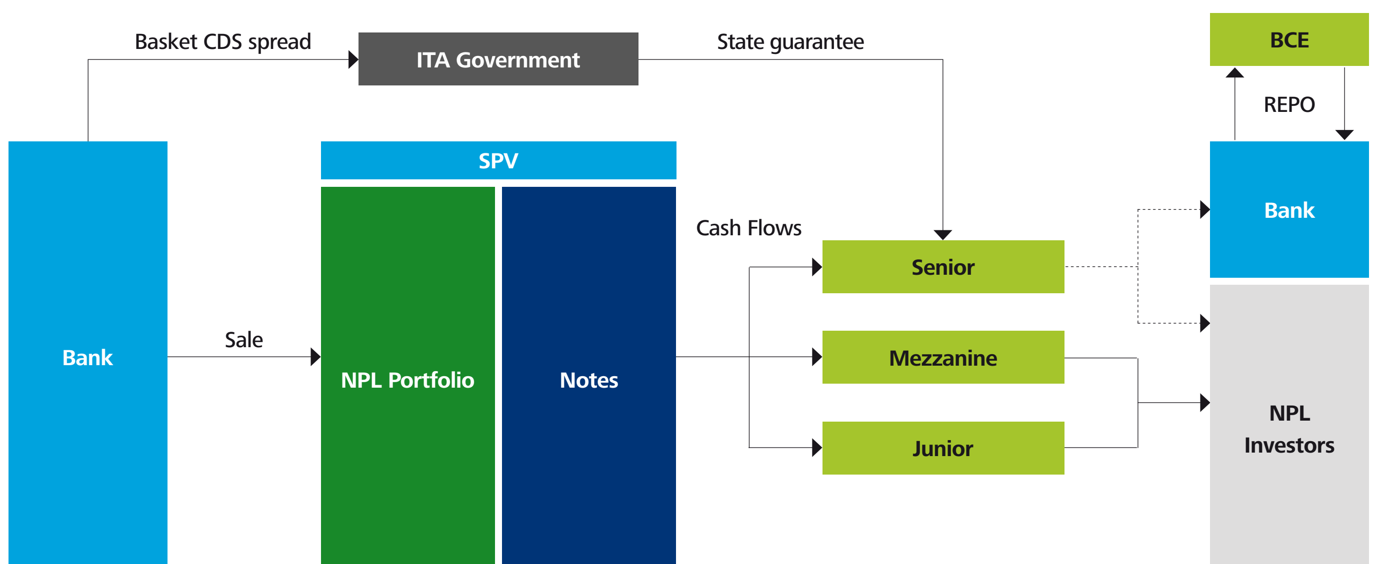
Banks will be required to appoint external independent servicers to carry out loan recovery to prevent any possible conflict of interests.

PROPOSED STRUCTURE

The scheme provides for the possibility for banks to transfer NPL portfolios to securitisation vehicles that will finance the acquisition through the issuance of notes in different tranches. Banks will be required to appoint external independent servicers to carry out loan recovery to prevent any possible conflict of interests. Junior note holders will have the right to change the servicers without limitations.

In case of deconsolidation of the underlying loans, the Italian government shall guarantee only senior tranches and only after the securities have received a rating equal to or higher than Investment Grade from at least one rating agency on a stand-alone basis (without taking into account the State guarantee). Among other things the rating will be based on: (i) cash flows analysis; (ii) collateral value analysis; (iii) credit quality of the underlying claims/loans; (iv) invested amount in the more junior notes; and (v) the operating capacity of the appointed special servicer.

State guarantee is not mandatory and may be requested by banks in the context of NPL securitisations against a periodic payment to the Italian Treasury. The guarantee price is calculated on the basis of a basket of single name Italian issuers CDS with the same rating associated to the guaranteed securities and will be time varying to cover for increasing risk and provide an incentive to recover loans in the most efficient way.



GUARANTEE PRICING MECHANISM

Guarantee pricing will be based on a basket of single name CDS on Italian issuers (regardless of the nature of the issuer), taken from the Bloomberg database, whose underlying debt instrument is rated by S&P, Fitch or Moody's. The basket composition will be identified at the time of the approval of the guarantee. It will remain fixed over time and will depend on the actual rating of the eligible senior tranche of the NPL securitisation.

- If **BBB-/Baa1**, the basket will contain instruments rated BBB/Baa2, BBB-/Baa3 or BB+/Ba1.
- If **BBB/Baa2**, the basket will contain instruments rated BBB+/Baa1, BBB/Baa2 or BBB-/Baa3.
- If **BBB+/Baa1**, the basket will contain instruments rated BBB/Baa2, BBB+/Baa1 or A-.

The CDS basket value will be calculated using Bloomberg mid-prices simple average of the previous 6 months. In case the rating for an underlying debt instrument in the basket changes over time, so that it falls outside the above threshold, it will be excluded from the calculations.

Banks that will participate in the scheme will have to pay a step up fees calculated on the basket CDS as follows:

- Years 1, 2 and 3: 3 years CDS on the senior tranche outstanding amount.
- Years 4, 5: 5 years CDS on the senior tranche outstanding amount + penalty equal to the difference in payments from a 5 years benchmark CDS held over years 1 to 5 compared to the actual payments made in years 1 to 3.
- After year 5, 7 years CDS on the senior tranche outstanding amount + penalty equal to the difference in payments from a 7 years benchmark CDS held over years 1 to 7 compared to the actual payments made in years 1 to 5.

MARKET IMPLICATIONS

At this stage it is still difficult to properly assess the short and medium term consequences of this reform as the market is expected to grow substantially in the next 18 months even without a State intervention.

The Italian government has pointed out that this scheme is only an element of a package of reforms aimed at strengthening the financial system that includes, among other things, the reform of the *Popolari* banks which is expected to further consolidate the banking system through M&A.

The scheme is designed to facilitate NPL sales only by providing a less expensive form of financing to NPL investors (saving ca. ~ 200bps according to JP Morgan and Mediobanca). However, in this scenario the price gap will be reduced only partially as the transaction value shall increase only by 4% to 6% (assuming a duration between 2 to 3 years) and the originator banks will still have to pay for the guarantee over the life of the senior notes (ca. 90bps according to JP Morgan and Mediobanca). Furthermore, it is still not clear what type of credit rating the senior tranches might have and what form of credit enhancements will be needed to achieve the rating envisaged by the government.

What seems clear at this stage is that the current proposal is not the single, defining solution for the large stock of NPLs sitting on Italian banks balance sheets and further measures need to be introduced. Additional legal system reforms aimed at shortening recovery time and more proactive deleveraging strategies by the banks themselves will be needed to accelerate NPL resolutions.

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