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The Deloitte Italian NPL Outlook
2014-2015

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About this paper
This paper is the second Deloitte article written about the Italian NPL market.
In 2012, we issued The Deloitte Italian NPL Survey Outlook for 2012-2013.

Introduction

KEY POINTS

In 2013 Italy emerged from a double-dip recession which had lasted nine successive quarters.

THE VOLUME OF ANNUAL CORPORATE INSOLVENCIES WAS 27% HIGHER IN 2013 COMPARED TO 2010.

Credit is becoming more available for mortgage borrowers but remains in limited supply for corporates and small-medium sized enterprises (SMEs).

UNEMPLOYMENT PEAKED AT 12.8% IN DECEMBER 2013.

THE EUROPEAN CENTRAL BANK'S ASSET QUALITY REVIEW (ECB AQR) EXERCISE COVERS 15 ITALIAN BANKS WITH RESULTS DUE IN OCTOBER 2014.

There has been a series of initiatives to stabilise and improve the Eurozone banking sector:

- European Banking Authority (EBA) recommendation regarding a **9% Core Tier 1** capital ratio
- **€1 trillion** of long-term refinancing operations (LTRO) funding
- In June 2014, **€400 billion** of targeted long-term refinancing operations (TLTRO) monies to provide liquidity for small-medium sized enterprise (SME) lending.

SOME ITALIAN BANKS HAVE BEEN INCREASING THEIR ANNUAL LOAN LOSS PROVISIONS AND/OR SEEKING TO RAISE ADDITIONAL CAPITAL AHEAD OF THE AQR RESULTS.

Some Italian banks are implementing or considering 'bad bank' structures similar to those seen in UK, Ireland and Spain.

€162bn

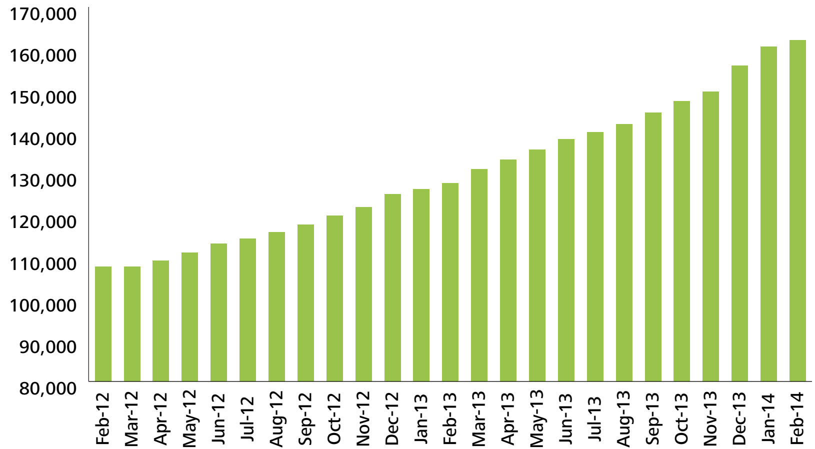
Reported gross bad debt levels now total €162 billion as at February 2014 and non-performing loans (NPLs) across all categories, including restructured and past due, are estimated at €316 billion for the year ending 2013.

THE VOLUME OF ITALIAN NPL PORTFOLIO TRANSACTIONS REMAINS SMALL BUT IS EXPECTED TO INCREASE SIGNIFICANTLY OVER THE NEXT TWO TO THREE YEARS AND PARTICULARLY POST THE AQR EXERCISE.

TWO TO THREE YEARS

BANKS EXPECTED TO SELL BETWEEN **€3 BILLION** AND **€6 BILLION** IN THE CURRENT CYCLE.

Figure 1. Italian NPL growth (€bn)



Source: ABI

In 2012, the Deloitte Italian NPL Survey made several predictions:

- NPLs would continue to affect bank balance sheets.
- The fastest rate of growth would be in corporate NPLs.
- Banks expected to sell between €3 billion and €6 billion in the current cycle.
- Consumer debt would be the most popular asset type to be sold.

Eighteen months on, all of the above predictions have been proved correct.

In the 2012 NPL Survey, we advised that the Italian Banking Association (ABI) had reported a rise in gross NPLs to €108 billion, the highest level since 2000. In April 2014 the ABI advised that gross NPLs have now increased to €162 billion as shown in Figure 1, a 50% increase within two years.

According to the Bank of Italy, in the first three months of 2014, Italian banks sold or securitised bad debts amounting to €2 billion, compared with €3 billion for the whole of 2013 (of which more than €1 billion was in December). The majority of these transactions related to consumer loans.

In 2014, and for the next couple of years, we predict that portfolio sales will increase significantly for a number of reasons:

- Continued supply of bad debts within the sector as a result of the recent economic stress.
- Capital shortfalls to be resolved following the ECB AQR exercise.
- A narrowing of the bid – ask gap between the carrying value of loans and the price expectations of investors, as a result of increased coverage ratios and a more favourable economic outlook.

The Italian macroeconomic backdrop – Green shoots …?

Gross domestic product (GDP)

Italy experienced a double-dip recession between 2011 and 2013, with the second phase of the downturn more severe in scale and duration compared with other countries in the Organisation for Economic Co-operation and Development (OECD) defined euro area as illustrated in Figure 2.

The peak-to-trough decline of 7.8% in real GDP across a total of nine quarters of recession ended in Q4 2013 with 0.1% growth. Whilst the economy slipped once again into negative territory in Q1 2014, the International Monetary Fund (IMF) in its World Economic Outlook has predicted growth of 1.1% in 2015.

The economic decline has had a profound effect on both corporates and consumers. According to the Bank of Italy, there were 57,000 corporate insolvencies in 2013 compared with 45,000 in 2010 and the IMF reported that one third of Italian firms are thought to have interest payment coverage at a vulnerable level.

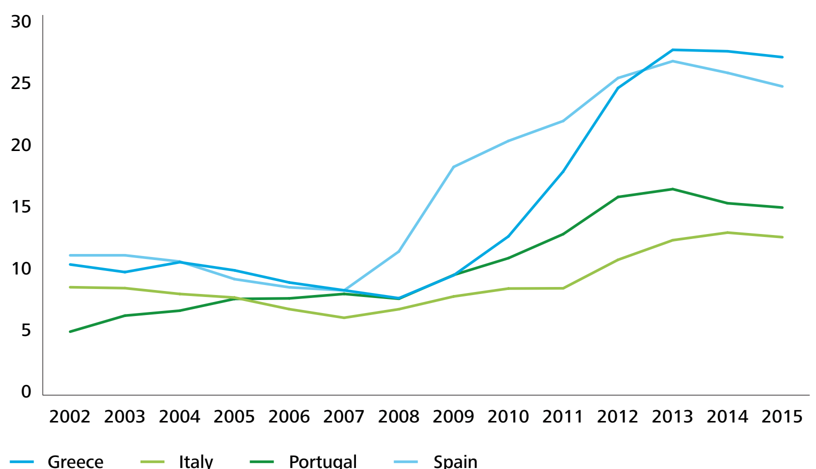
Figure 2. Real GDP Growth (%)

Source: OECD Stat Extract

The labour market

Corporate insolvencies eventually impact on unemployment levels, and the current unemployment rate is 12.6% (slightly below the peak of 12.8% in December 2013, Figure 3 refers). According to the OECD, Italy has the fifth largest unemployment rate in the Eurozone, after Greece (26.7%), Spain (24.4%), Portugal (14.8%) and Slovakia (13.6%). Trends in unemployment are a key element in the analysis by investors looking at consumer loan portfolios. Consumer loans have been the most actively traded asset type, and if unemployment levels begin to decline, asset prices could start to rise.

Figure 3. Unemployment rate (%)



Source: OECD Stat Extract

Real estate

In the past 15 years or so, corporates and consumers in Italy have not over-extended themselves, compared to borrowers in other European countries. The level of indebtedness as a ratio of income or earnings was 74% in December 2012, compared to a European average of 109%.

Such prudence is likely to have protected some individuals and businesses from the softening of the real estate market where prices have fallen and the volume of transactions has declined. Residential property prices were 4.8% lower in December 2013 (Figure 4) compared to the previous year, whereas non-residential property prices were broadly flat (Figure 5). The volume of transactions for non-residential property remains significantly below levels seen as recently as 2011.

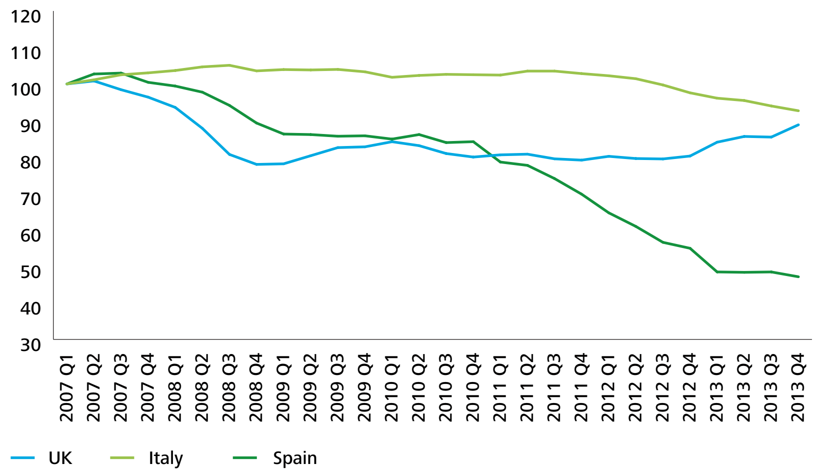
Credit availability

As with most other European countries, there is pressure to increase credit availability but Italian banks remain cautious about underwriting new business. New mortgage lending has bucked this trend, with Q1 2014 lending up almost 10% on 2013. Credit for corporates continues to contract, down 4.2% on an annual basis in March 2014.

The announcement in June this year of €400bn of TLTRO, covering a four-year maturity at 25 basis points per annum, is aimed at increasing the level of credit made available to the SME sector. Whilst the terms are favourable and the scale of funds significant, it is too early to predict whether this initiative will lead to an increase in SME lending and banks taking on additional risk, or whether deleveraging will remain the priority for many institutions.

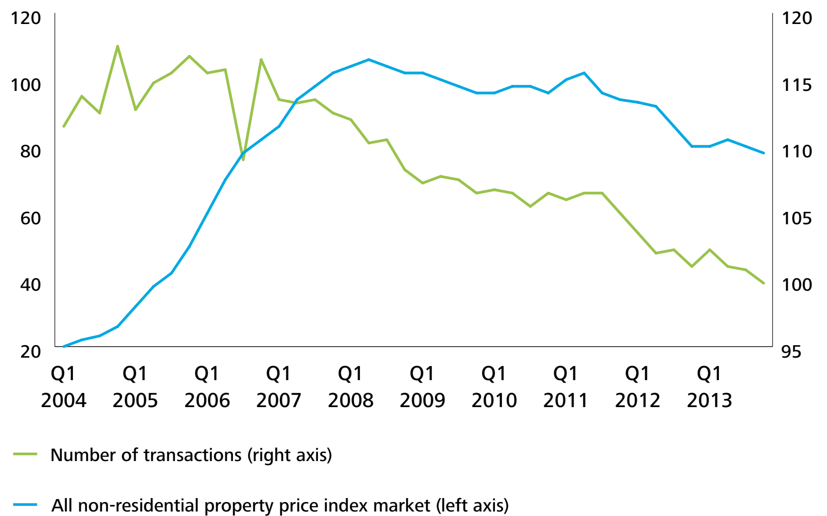
Given the restricted amount of credit available to the SME sector and high borrowing costs, some investors – 'alternative lenders' – are looking to acquire SME loan portfolios with a view to providing direct lending to those clients. It remains to be seen whether this investor interest will remain following the TLTRO cheap funding initiative and potentially increased competition to fund this sector.

Figure 4. Residential property indices



Source: ECB Eurostat

Figure 5. Italian non residential property market (indices 2005=100)



Source: Banca d'Italia financial stability report 2014

A challenging few years for the country and its banks

THE ITALIAN ECONOMY APPEARS TO HAVE RECOVERED FROM THE RECENT TURBULENCE, BUT CAN BANKS DO THE SAME?

Public finances

In October 2011, there was rumour in the market of an impending Italian default. Bank deposits and credit availability were at their lowest levels for 12 months, the inter-bank market remained frozen and Italian ten-year bonds were yielding over 7%, as shown in Figure 6.

The survival of the Eurozone was being questioned and NPL investors were understandably sitting on the fence waiting to see how the turmoil played out before investing sizeable funds in NPL transactions.

Two-and-a-half years later and the risk of default is a distant memory and Italian ten-year bond yields are below 3%. This turnaround in fortune has been achieved in various ways. Three pivotal moments are outlined below:

1. The EBA's creation of temporary capital buffers to restore market confidence in the EU banking system. In November 2011 the EBA announced a recommendation for certain banks (including the Top 5 Italian banks) to strengthen their capital positions by building up an exceptional and temporary buffer, such that their Core Tier 1 capital ratio should reach a level of 9% by the end of June 2012.
2. The ECB's LTRO provided €490 billion of three-year money, at an interest rate of 1% in December 2011, and a further €530 billion two months later, in order to end the liquidity crisis in Europe. Italian banks were the largest takers of the funds, obtaining a total of €255 billion over the two instalments according to Reuters.
3. In a speech at an investment conference in London in July 2012, Mario Draghi stated: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

Collectively, these events have resulted in much reduced borrowing costs for Italy.

Italian banks have been repaying LTRO monies as shown in Figure 7, bond yields are below 3% and NPL investors have returned with a vengeance, as evidenced by the number of investors reported to be looking at the largest Italian NPL transaction for years, UniCredit's Project Romeo.

Figure 6. 10-year government bond yields (%)

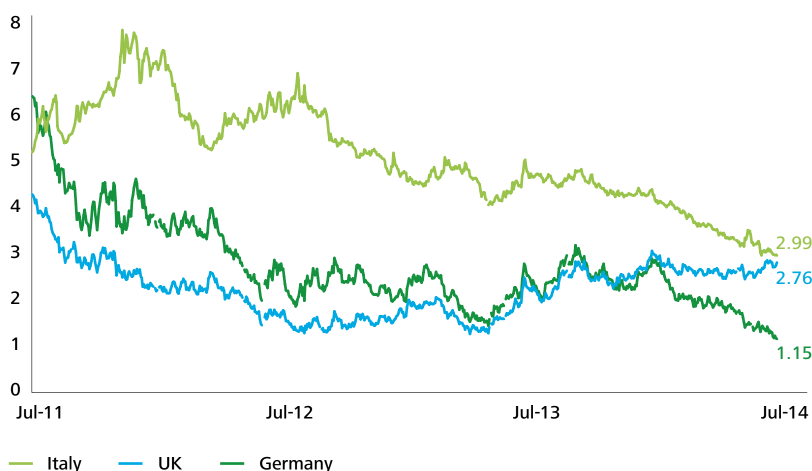
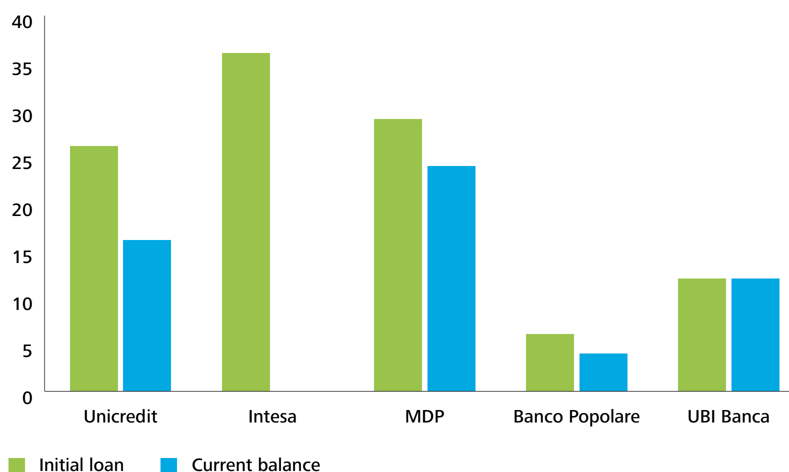


Figure 7. ECB LTRO Funding (€bn)



Source: Company accounts and presentations, Reuters

Will the ECB's AQR destabilise or accelerate the banking sector's recovery?

Central bank inspections

Asset quality reviews by the Bank of Italy are nothing new. Will the asset quality review currently being undertaken by the Bank of Italy on behalf of the ECB be any more severe than those in the past? The ECB AQR raises many questions for investors and banks alike.

The central bank has carried out inspections of smaller banks on average every 3.5 years, and supervision of larger banks has been more extensive. During the period 2009-2011, the Top 5 largest Italian banks (by assets) were subject to inspection for 60% of the time, and the Top 2 for 85% of the time.

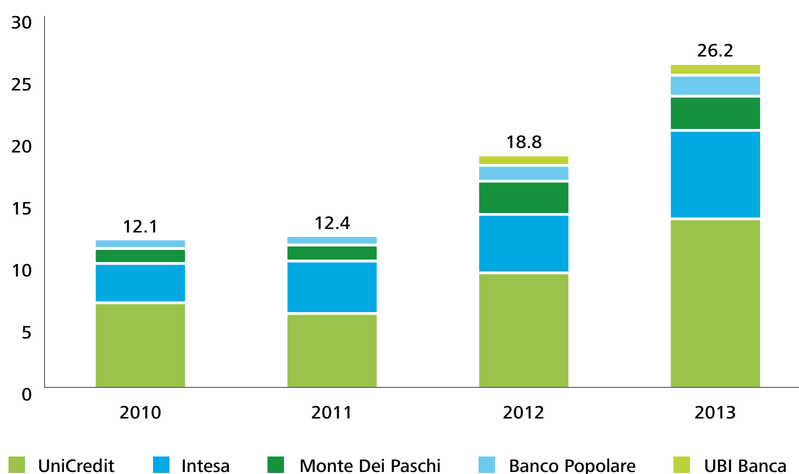
In 2012 the Bank of Italy launched a new initiative, focusing on coverage ratios and provision policies. The inspections required individual credit file reviews being performed on-site and data-driven provisioning reviews performed off-site.

The Autumn 2012 inspections covered 20 banks, €24 billion of debts and 5,200 loans. The banks targeted were those with lower-than-average coverage ratios or whose ratios had fallen significantly. The objective of the exercise was to assess the adequacy of the provisions and to examine provisioning policies and practices.

The central bank found deficiencies in collateral valuation and discounting parameters within certain banks, and for some of these, additional provisions were required. Coverage ratios increased from 31% in September 2012 to 43.5% in December 2013.

As a result of its findings, the central bank also asked banks to reduce their operating costs, dividend payments and remuneration levels, and also consider the sale of non-strategic assets. Banks have subsequently reduced operating and staff costs with the sector averaging a cost: income ratio of 62% in 2013, largely contained dividend payouts although the sale of non-strategic assets has really yet to take place.

Figure 8. Annual loan loss provisions (€bn)



Source: Annual financial statements, quarterly presentations, Deloitte research

The impact of the Autumn 2012 inspections on loan loss provisions can be seen in Figure 8. Provisions made in 2012 were 50% higher than the €12.4 billion in 2011.

Figure 8 also shows the large increase in annual loan loss provisions from €18.8 billion in 2012 to €26.2 billion in 2013. This was driven predominantly by the two largest banks and may have been due to further Bank of Italy inspections during 2013 or to concerns about the imminent ECB AQR initiative.

The ECB AQR exercise covers 128 institutions across Europe, of which 15 are Italian, as shown in Figure 9.

European Central Bank Asset Quality Review

It is estimated that the average number of loan credit files being reviewed at each of the 15 Italian banks in the ECB AQR exercise is about 1,000, compared to a total of 5,200 loans inspected by the Bank of Italy in Autumn 2012. The ECB AQR is clearly much broader in terms of coverage. According to the ECB, the AQR covers 58% of the total credit RWA of banks in the exercise.

The objectives of the overall ECB AQR and stress testing are:

- Transparency
- Repair
- Confidence building

The objectives are to be achieved by a review of:

- Processes, policies and accounting
- Banking book exposures (data integrity validation, credit file reviews and collective provision analysis)
- Level 3 fair value analysis (trading book and derivative reviews)

For businesses that are no longer a going concern, the banking book reviews are based on asset valuations. For borrowers that are a going concern, the provision calculations are based on a multiple of sustainable cash flows to debt service costs. A multiple of six times is being used for standard businesses.

Evidence of forbearance, or concessions extended to debtors who face (or may face) difficulties in meeting payments, are also to be identified and quantified.

The review is ongoing and an announcement of results is due in October 2014.

Figure 9. Italian AQR Banks

Bank
Banca Carige
Banca Monte dei Paschi di Siena
Banca Piccolo Credito Valtellinese
Banca Popolare Dell'Emilia Romagna
Banca Popolare Di Milano
Banca Popolare di Sondrio
Banca Popolare
Credito Emiliano
Iccrea Holding
Intesa Sanpaolo
Mediobanca
UniCredit
Unione Di Banche Italiane
Veneto Banca

Source: ECB note on Comprehensive Assessment

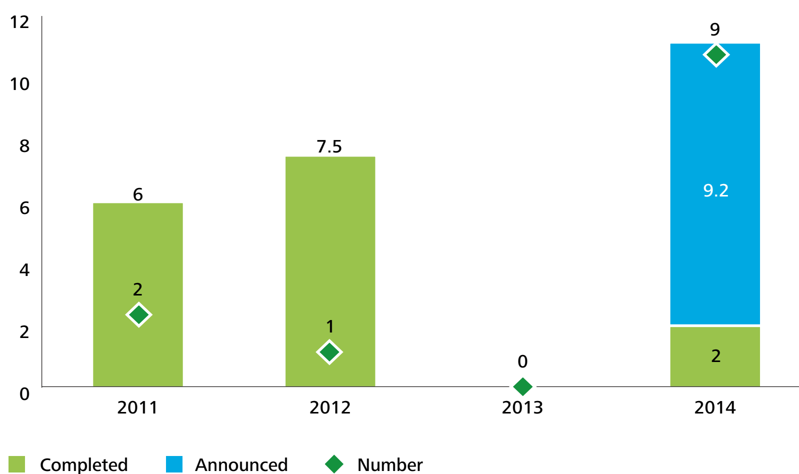
Whilst we showed in Figure 8 the increase in provisions that may have been prompted by the 2012 inspections, the much larger increase in provisions in 2013 may be due to banks pre-empting the outcome of the ECB AQR.

According to the EBA, in 2013 the Euro-area banks raised over €80 billion in capital and, in 2014, they will raise over €60 billion according to some market estimates.

In Italy, during 2014 nine banks have already approached the market for fresh equity: this compares to 2013 when there were no completed rights issues by banks (Figures 10 and 11). It seems an unlikely coincidence that the €7.4 billion increase in provisions and nine rights issues should both occur in the year of the ECB AQR.

The market is anticipating additional loan impairments. Morgan Stanley's AQR Survey Results report estimated that the shortfall across all 128 of the AQR banks could be between €20 billion and €80 billion. Such capital shortfalls in individual banks could be resolved by further recapitalisations, sector consolidation, portfolio and business sales or possibly also bank failures.

Figure 10. Italian banks – rights issues (€bn)



Source: Annual financial statements, quarterly presentations, Deloitte research

Figure 11. Italian banks – rights issues

Bank	Date	Amount (€m)
Intesa	Jun-11	5,000
UBI Banca	Jul-11	1,000
Unicredit	Jan-12	7,500
Banco Popolare	Jan-14	1,500
Banca Popolare di Milano	May-14	500
Monte Dei Paschi	Jun-14	5,000
Banco Popolare di Vicenza	Announced	1,000
Veneto Banca	Announced	850
Banca Carige	Announced	800
Banca Popolare Emilia Romagna	Announced	750
Piccolo Credito Valtellinese	Announced	400
Banca Popolare Di Sondrio	Announced	350
Total		**24,650**

Source: Deloitte research, various press articles

Are the banks sufficiently provisioned to sell?

ITALIAN BANKS HAVE MADE SIGNIFICANT LOAN LOSS PROVISIONS IN THE LAST TWO YEARS, CLOSING THE POTENTIAL BID-ASK GAP BETWEEN SELLERS AND BUYERS OF NPLS

Bad debts

The stock of NPLs across all non-performing loan categories including restructuring, substandard and past due in the Italian banking system, is concentrated in the Top 5 banks with €207.8 billion, 66% of the sector total of €316 billion (Figure 12), which is the largest volume of NPLs in any Eurozone country.

As outlined earlier, Italian banks have recognised significant levels of loan loss provisions in the past two years. In 2012 the Bank of Italy inspections resulted in a 52% increase in provisioning on the previous year; and in 2013, in advance of the ECB AQR review, the banks went further than was expected, posting €26.2 billion of loan loss provisions.

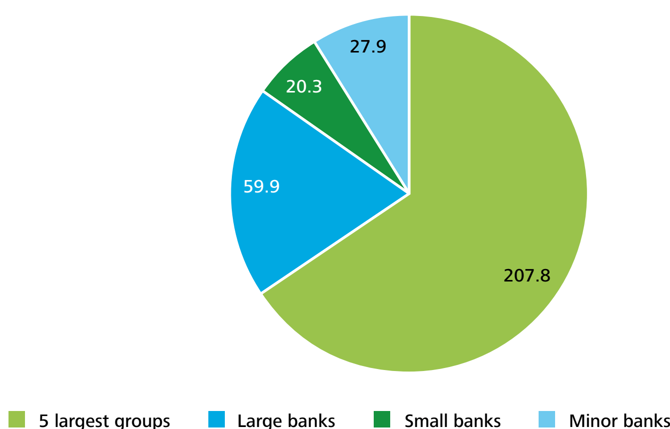
The uplift in provisions has increased the coverage ratio for non-performing loans (Figure 13). The two largest banks, UniCredit and Intesa, now have coverage ratios that compare favourably with other large European Banks. The increased provisioning should have reduced the bid-ask gap between banks and investors, and this is likely to narrow further once the ECB AQR process has completed if additional loan impairments are identified.

The narrowing of the bid – ask gap is significant. As reported in the Deloitte Italian NPL Survey 2012-13, according to banks it was the main factor for deals not completing and other potential transactions not coming to market.

On the assumption that banks and investors have compatible views about risk assessment and expected cash flows, the bid – ask gap should be limited to the difference between the investor's yield requirements and the bank's cost of capital.

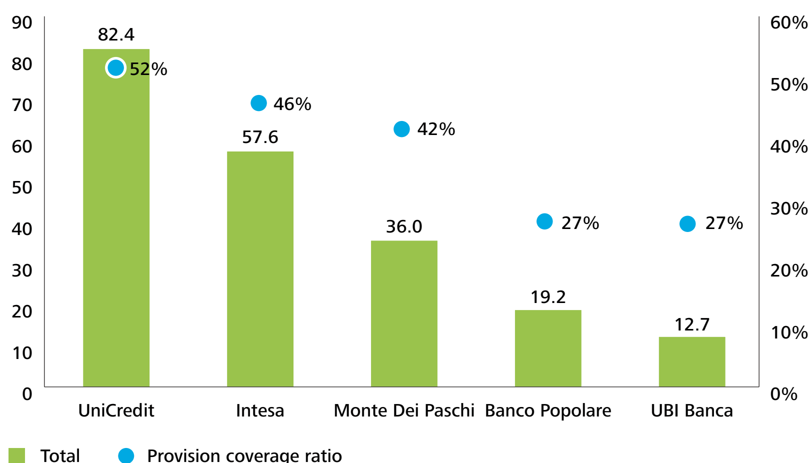
The gap could be narrowed further if investors are able to secure debt (as oppose to all equity) to fund part of the purchase cost of a loan portfolio, as we are seeing in the UK, Spanish and Irish markets. In these countries, the loan to purchase (LTP) price offered by banks willing to lend to investors has increased to 60-70% from 50% in 2011. The interest rate margin that these banks charge an investor for such funding has also reduced significantly from about 700 basis points to 300 – 400 basis points over a similar period as the level of competition within the debt capital market increases.

Figure 12. Non-performing loans as at Dec 13 (€bn)



Source: Annual financial statements, quarterly presentations, Deloitte research
Note: Non performing loan definition encompasses all loans not defined as performed (i.e. substandard, impaired, bad loans, doubtful, watchlist loans, restructured and past due)

Figure 13. Non-performing loans (€bn) and provision coverage ratios as at Dec-13



Source: Annual financial statements, quarterly presentations, Deloitte research
Note: Non performing loan definition encompasses all loans not defined as performed (i.e. substandard, impaired, bad loans, doubtful, watchlist loans, restructured and past due)

Are the banks structurally and strategically ready to sell?

IN EUROPE, FINANCIAL INSTITUTIONS WITH NON-CORE DIVISIONS AND COUNTRIES WITH BAD BANKS HAVE BEEN THE MOST ACTIVE IN SELLING LOAN PORTFOLIOS

5

BELOW THE **TOP 5 BANKS**, THERE IS LESS POTENTIAL FOR NPL SALES ON A **LARGE SCALE** …

Bad banks

In contrast to the UK and Ireland, Italy's largest banks have only recently started to set up internal non-core divisions. The two largest banks, UniCredit and Intesa, have established an internal 'bad bank' division to house non-core assets, and have set out deleveraging strategies which include potential NPL sales. Although the other banks within the Top 5 have been less specific on this issue, their management have indicated that NPL sales may be used to accelerate reductions in non-core assets.

Below the Top 5 banks, there is less potential for NPL sales on a large scale although smaller portfolio sales (below €50 million gross book value) may continue. The mid-sized banks' lower level of provisioning against bad debts, combined with their often complex governance structures, means that significant NPL sales in the sub-sector are unlikely over the next 12 months.

Any increase in merger activity in this sector, which is being actively encouraged by the Bank of Italy, may lead to disposal activity; but we would not expect any such portfolio sales within the first 12 months of a merger as the initial focus would be on integration.

There are no plans in place for the establishment of a government-funded 'bad bank' along the same lines as UK Asset Resolution in UK, NAMA in Ireland and SAREB in Spain. The Government has discouraged the idea because of a potential threat to the credit rating of sovereign debt. However, the Governor of the Bank of Italy, Ignazio Visco, indicated that it may be a possibility when he announced the consideration of 'more ambitious interventions' to assist in the sale of impaired assets.

Figure 14. Top 5 banks' non-core structures and NPL strategies

Bank	Non-core structure	NPL strategies	Potential for NPL sales in 2014/15
UniCredit	• Non-core division established • 1,100 professionals assigned to non-core with separate reporting going forward • Portfolio consists of €87bn of loans of which 67% are non-performing • Non-Italian assets have not been transferred to the division	• Reduce non-core assets (both performing and non-performing) by 63% from 2014 to 2018 • €2-2.5bn per annum NPL sales target	
Intesa	• Non-core division established • 700 professionals assigned to non-core • €46bn of assets transferred to the division, €27bn of which are loans, with the remainder being real estate and equity stakes	• Reduction of all non-core assets by 50% by 2017 • Not specific details, but NPL sales likely to be part of the disposal strategies	
Monte dei Paschi di Siena	• Separate non-core division not established	• Loan deleveraging of €9bn planned by 2017 • No stated NPL disposal strategy but has been selling in 2013 and 2014	
Banco Popolare	• Separate non-core division not established • Management have stated that non-core re-organisation is under review	• No specific targets set • Two potential disposals in 2014 have been announced	
UBI Banca	• Separate non-core division not established	• Management have not yet announced a deleveraging strategy	

Source: Annual financial statements, quarterly presentations, Deloitte research

The burden of €162bn of NPLs. Time to sell?

Completed deals

In recent years NPL market activity in Italy has been limited in contrast to the UK, Ireland, Spain, Portugal and Germany. A significant obstacle has been the bid-ask spread between the carrying value of loans and the price expectations of investors. Limitations in the quality of portfolio data, and concerns over the efficacy of the Italian enforcement regime have also been barriers to successful transactions.

All reported large NPL transactions in the last 18 months have related to unsecured portfolios (as shown in Figure 15), with bid-ask spreads being noticeably wider for real estate assets.

Future prospects

The prospects for a more stable economy and potential upturn in the Italian real estate market, coupled with more realistic provision levels, suggest that an increase in NPL transactions is likely in the near term.

Indeed, we have already noticed a slight increase in the volume of transactions during the last 12 months, as indicated in Figure 15, whilst also recognising that this is a private market and not all completed transactions are publicly announced.

As competition for distressed assets intensifies in the more established European NPL markets, investors are likely to turn to Italy, to take advantage of potential opportunities. The recent memorandum of understanding between KKR, UniCredit and Intesa to create a bad bank to house NPL loans is a clear demonstration of this trend. In June 2014, Banco Popolare also announced that it was in discussions to sell a stake in its loan management business, Release, with a gross loan balance of €3.2 billion (the transaction has since been aborted), and we are aware of two other live deals, one involving a foreign bank and the other an Italian bank.

The non-performing loan exposures of the large Italian banks are concentrated mainly in the domestic Italian market, although some institutions have foreign assets, especially in Central and Eastern Europe that could become available for sale following the ECB AQR, especially if the NPL market in that region becomes more active as other institutions, possibly Austrian, look to sell loan portfolios.

Figure 15. 2013/2014 Italian NPL portfolio sales as publicly reported

Seller	Buyer	Type	GBV (€'m)	Date
Fiditalia	AnaCap	Unsecured	1,500	2013
Santander	Toscana Finanza	Unsecured	208	2013
Agos	Undisclosed	Unsecured	500	2013
BCC	Christofferson	Unsecured	150	2013
MPS	AnaCap	Unsecured	551	2013
UniCredit	Cerberus	Unsecured	950	2014
UniCredit	AnaCap	Unsecured	700	2014
UniCredit	Mariner	Subordinated debt	910	2014
Creval	Ares	Secured	36	2014
CR Ravenna	HIG	Secured	undisclosed	2014
MPS	Fortress	Sec/unsec	500	2014

Source: Press articles

There are also foreign banks with Italian loan exposures. These institutions have been able to sell unsecured portfolios successfully, but as yet there has been no reported disclosure of a sizeable corporate, commercial real estate or residential mortgage transaction. This inertia (for foreign and domestic banks) will change as mortgage lending increases and the real estate market recovers with regards to price and liquidity.

In the last few years, deleveraging has been significant and EU banks have cut around €4 trillion in total assets according to the EBA. Whilst much of this has been via 'hold to maturity' strategies, the small increase in deal flow in Italy over the last 18 months is encouraging and suggests that banks are more willing to consider portfolio sales.

In 2014, the ECB AQR is a key driver, what will be the key driver in 2015?

Contacts

This paper was written by Jon Daniel, a Director in Deloitte's Portfolio Lead Advisory Services team and researched by David Nathan, a Manager in the team.

The team specialises in NPL and non-core sale transactions, having advised clients in Italy and the rest of Europe during the global financial crisis.

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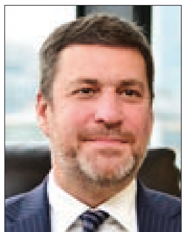

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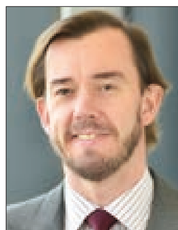

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