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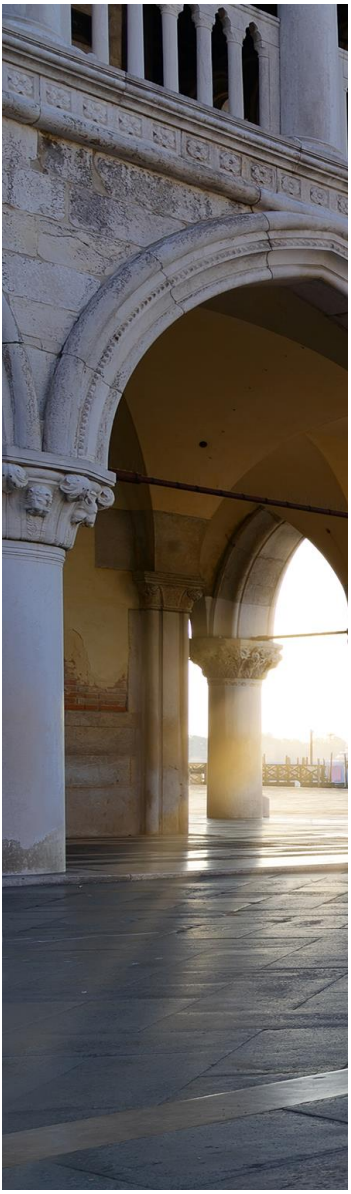

The Italian Unlikely to Pay Market

The Next Big Wave

pwc

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Disclaimer: PwC analyses are based on banks' financial statements from FY 2015 to FY 2018 and Data Provider dataset

The Unlikely to Pay segment

The market in 2018 and our view on 2019

Foreword | The market in 2018 and our view on 2019

Italian Banking sector and the NPE market witnessed a disruptive moment over the last three years (2015-2018):

- NPL transactions reached a volume of c. €190bn;
- Gross NPE volumes significantly dropped from €341bn to €180bn (of which from €127bn to €79bn for UtP);
- NPE ratio decreased from 22% to 12% (from 8% to 5% if related only to UtP);
- NPE coverage increased from 45% to 54% (from 27.6% to 36% for UtP*);
- Nine major Italian banks were subject to liquidation procedures or bailout measures. A potential new wave of consolidation in the banking sector might follow;
- Branches were cut down from #30k to #25k;
- New players, named "challenger banks", entered the market introducing an innovative business model, affecting even the UtP management matter;
- Servicing sector featured a massive consolidation path and impressive increase of AuM (from €121bn to €171bn in the period 1H16-1H18 for the Top 10 players), placing themselves in the UtP management arena.

As at 31 December 2018 UtP exposures decreased to €79bn (GBV) and €51bn (NBV) compared to 2017 volumes (respectively €94m and €66bn). In terms of net book value, UtP firmly surpassed the bad loans which account for €97bn in terms of GBV and €33bn in terms of NBV.

Thus, as the main portion of the NPE in the books of the Italian banks, UtP definitively represent the key factor in Italian banks' deleverage plans. UtP deleverage plans will take on a pivotal role in achieving financial markets' expectations and the goals and standards required by the Regulators.

On one hand, the huge pressure from the market still keeps down Italian banks' listing as highlighted by i) the inverse correlation between their market cap on tangible book value ratio and NPE ratio and ii) the performance of the listed Italian banks (FTSE Italia All Share Banks index) from January 2017 lower by c. 20% than the average market performance (FTSE MIB index).

On the other hand, the strict rules introduced by the Regulators will massively affect the UtP management and disposals. ECB will require minimum coverage ratios on NPE stock from 2020. EU Commission through the Calendar provisioning will expect the full coverage of the NPE after 8/10 years for secured loans and 4 years for unsecured loans. EBA, through the final guidelines on NPE management will set more strict governance and operational standards and cause the speed-up of their disposal process. Not to mention the application of IFRS9 that introduced an "early-warning and forward-looking approach" to credit risk impairment, resulting in higher NPE provisioning.

*Ratio calculated on the perimeter of Top 10 Italian banks

In our view, UtP more than an independent asset class, represents a temporary status of the borrowers classified as such. Hence, in setting the deleverage plans, the analysis and clustering of UtP to be carried on by the Italian banks is not an easy task. Banks must reconcile a single-name approach with a cluster / portfolio approach in order to define proper perimeters of UtP to be disposed or managed.

As a result, the UtP market is still at an early stage. On one hand, UtP portfolios sales in 2018, excluding the ones realised in the context of banks' bailouts, have been quite limited in terms of number and volumes: the main six closed transactions amounted to less than €3bn of GBV. On the other hand, those portfolios are not representative of UtP still in the books of the banks, being almost exclusively collateralised by Real Estate assets and "almost" bad loans in terms of asset quality.

New UtP portfolios are coming into the market and the announced transactions feature higher volumes as GBV and mid/large corporate loans (e.g. deleverage and servicing initiatives announced by Intesa Sanpaolo and UniCredit related to two UtP portfolios equal to c.€10bn and €3bn of GBV respectively).

In the eyes of the investors, UtP, as well, is a complex and disruptive asset class - compared to the mature Bad Loans' market. The successful management aiming at bringing the UtP borrower back in the performing status, will require strong specific expertise and competencies other than financing capabilities. The management of the UtP entails not only financing and refinancing capability but also industry expertise, restructuring / turnaround and legal skills and advisory approach. Financing could be provided through alternative financial structures: from more traditional measures of direct lending on a stand-alone basis or in partnership with the bank originator and debtor in possession financing, to more innovative solutions such as the recourse to restructuring funds and securitisations.

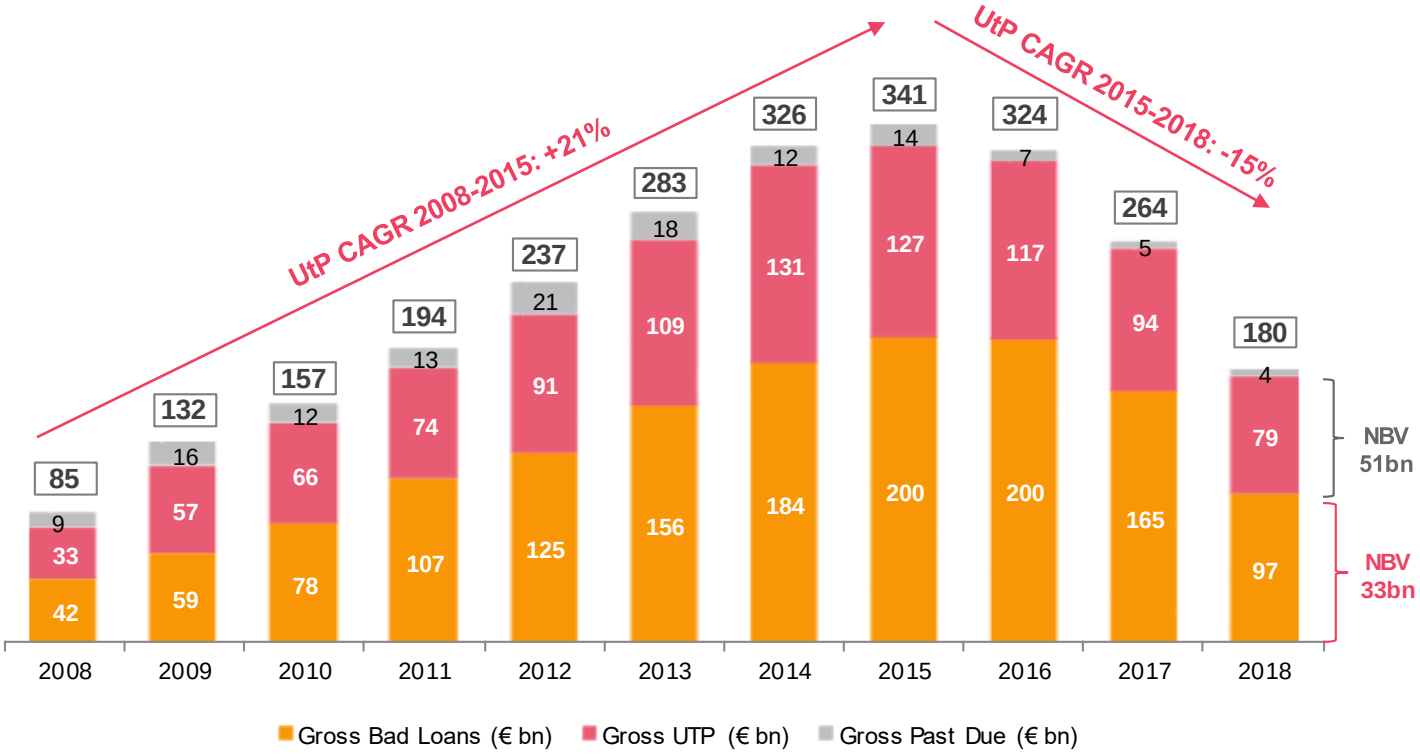
A crucial role in tackling the UtP issue will be taken on by challenger banks and NPL servicers. The former, combining together restructuring skills, financing capability, including working capital facility and flexible, IT driven, specialised collection strategies may place themselves as ideal partners of traditional banks in their deleverage plans. The latter, through their consolidated business models, scale economies and the ongoing conversion from massive to tailor-made approach may be the ideal outsourcer for traditional banks in driving the restructuring measures and speeding up the return of the UtP borrowers to the performing status.

Based on this lively and moving background, we strongly believe that UtP topic will represent the next big wave in the Italian banking system.


MARIAE
NASCENTI

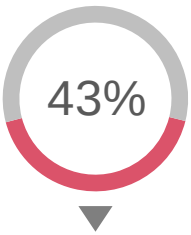
Asset Quality and Unlikely to Pay key figures

Non Performing Exposures ("NPE") volume in the Italian banking sector declined to a gross amount of €180bn, of which €79bn (44%) is classified as Unlikely to Pay ("UtP"). As of December 2018, UtP are ~1.5 times larger than Bad Loans in terms of net book value (€51bn vs €33bn respectively).

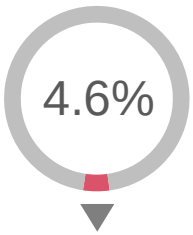


Source: Bank of Italy Report – «Condizioni e rischiosità del credito» updated Dec 2018

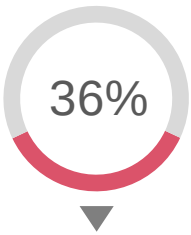
UtP Key Figures



Gross UtP/ NPE Ratio
(Average* - Top 10 banks)



Gross UtP Ratio
(Average* - Top 10 banks)



UtP Coverage Ratio
(Average* - Top 10 banks)

(*) Calculated as arithmetic average

Unlikely to Pay distribution
Top 10 Italian banks

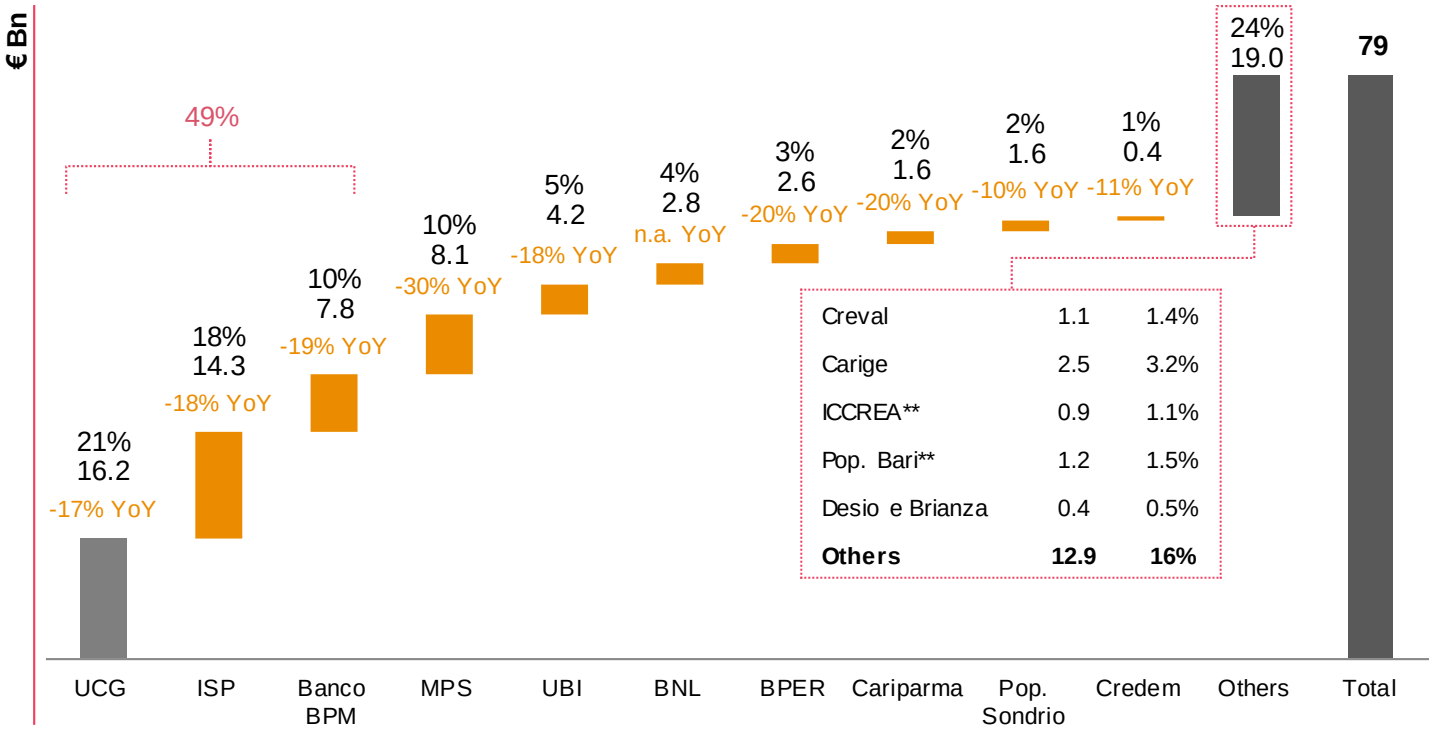
At the end of December 2018, Gross UtP held by Italian banks amounted to €79bn (GBV) of which 76% is concentrated within top 10 banks: despite the declining trend the UtP magnitude is still important.

UtP among top 10 Italian banks*

At the end of 2018 the overall UtP exposure is less concentrated than in 2017, thanks to recent disposal programmes promoted by top-tier banks (76% of total UtP exposure is concentrated in the top 10 Italian banks vs 82% in 2017). If only the top 3 Italian banks are considered, such percentage is 49%.

The UtP exposure declining trend, started in 2015 (-3% from FY 2014 to FY 2015), continued in 2016, 2017 and 2018 (-8%, -20% and -16% YoY respectively).

Despite the declining trend, UtP is becoming more and more crucial in the NPE issue: 43% of top 10 Italian banks' NPE are classified as UtP as of December 2018 (36% in 2017) and several banks are featuring gross UtP ratio on NPE over 40%.



42%	39%	66%	48%	43%	31%	37%	44%	38%	36%	Gross UtP/ NPE
8%	9%	11%	17%	10%	13%	14%	7%	15%	4%	Gross NPE Ratio

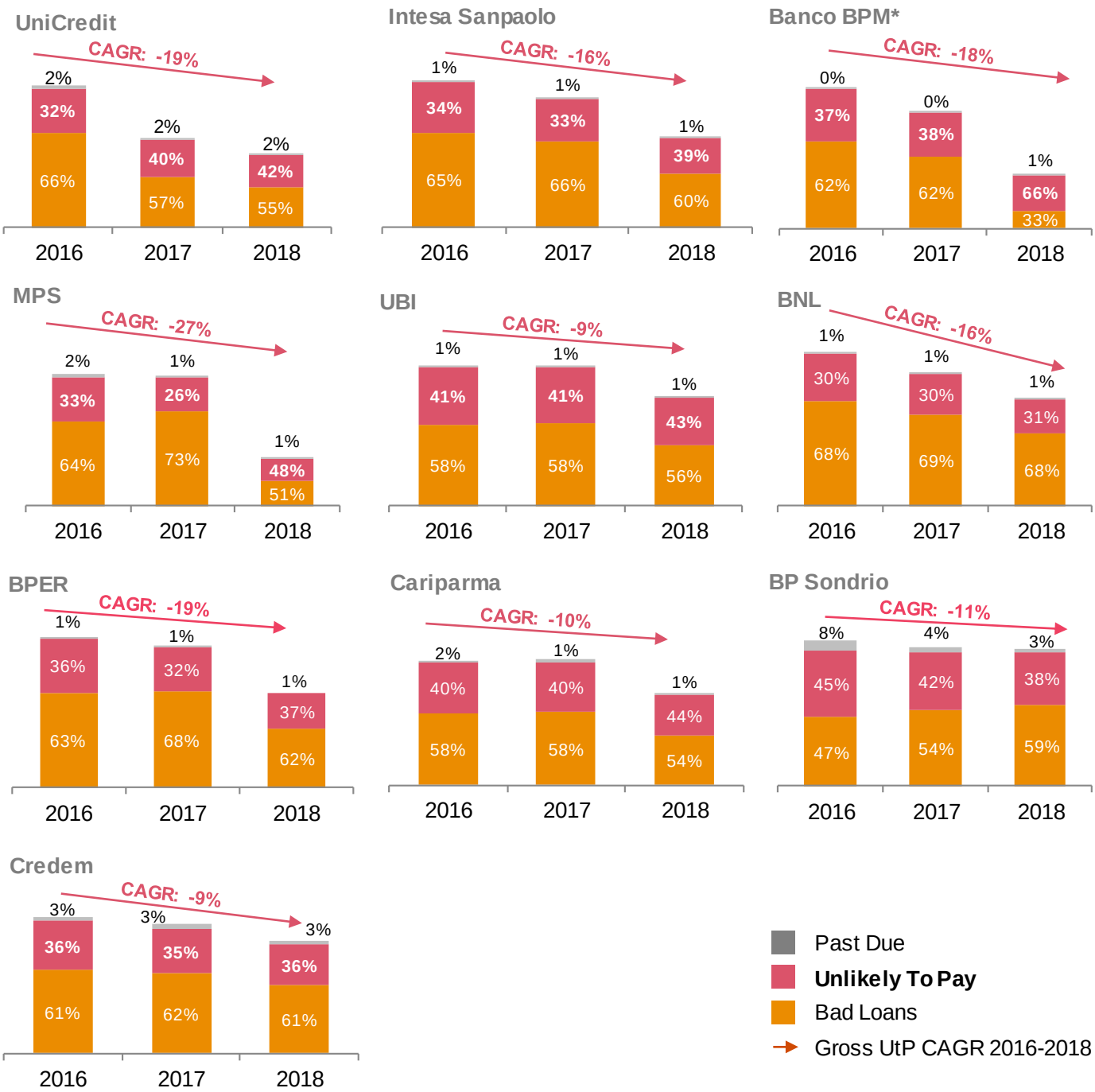
Source: PwC analysis of banks' financial statements as of Dec 2018
(*) The list of top 10 Italian banks is based on the Gross Book Value of Total Exposure as of Dec 2017 (source: ABI)
(**) ICCREA and Banca Popolare di Bari exposure as of Jun 2018

UtP Ratio on NPE

Breakdown of top 10 Italian banks

Despite the gross UtP exposure declining trend over the period 2016 / 2018 (-18% CAGR), their weight on the NPE of the top 10 Italian banks remains significant (43%).

NPE breakdown from 2016 to 2018 by bank



(*) Ratios of Banco BPM in FY 2016 (pre-merger) were calculated as sum of the figures of Banco Popolare and BPM (merged together in Banco BPM from 1 January 2017)

Source: PwC analysis of banks' financial statements as of Dec 2018 and Dec 2017

Unlikely to Pay Coverage ratio
Top 10 Italian banks

The UtP average coverage ratio of the top 10 Italian banks reached 36% (31% in 2017) while their ratio on total loans declined from 5.5% to 4.6%. Italian banks are on the right path but further efforts are required.

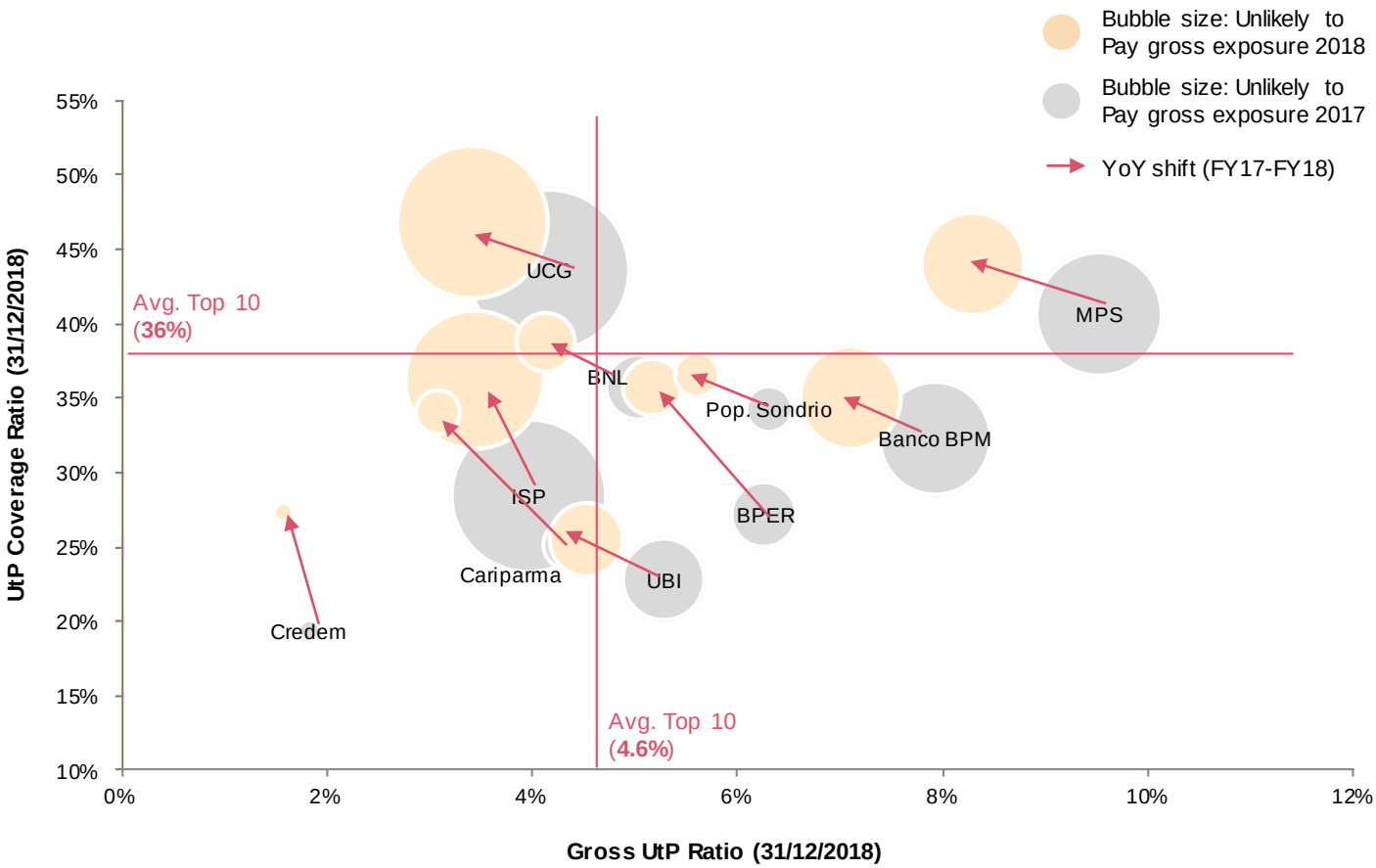
UtP Coverage ratios vs. Gross UtP ratios

Top 10 Italian banks significantly increased their UtP provisions in 2018 with respect to 2017, resulting in higher coverage ratios (avg. 36% in 2018, 31% in 2017). The main reason is banks' restatement of UtP reserves as of December 2017 after the entrance into force of IFRS 9, as explained in the following pages.

Among the top 10 Italian banks, Cariparma and BPER significantly increased their UtP coverage by 8.9 pp and 8.6 pp respectively.

Recent market trends are characterised by the set up of deleveraging strategies and reclassifications to Bad Loans: in terms of UtP stock, the declining trend showed in 2017 remained stable in 2018: Gross UtP ratio reduced by 1 pp from 2016 to 2017 and 0.9 pp in 2018.

Leading banks in reducing their Gross UtP ratio have been Cariparma (-1.3% vs 2017) and MPS (-1.2% vs 2017), mainly thanks to the first disposal projects carried out in 2018.



Source: PwC analysis of banks' financial statements as of Dec 2018 and Dec 2017

5.

Unlikely to Pay inflows and outflows from 2016 to 2018

Top 10 Italian banks

At the end of 2018, 55% of UtP remained as such. In percentage terms, inflows from Past Due and Performing are in line with 2017, as well as outflows to Performing and collections. The UtP issue for 2019 still lies in the management of their massive stock.

Outflows and Inflows

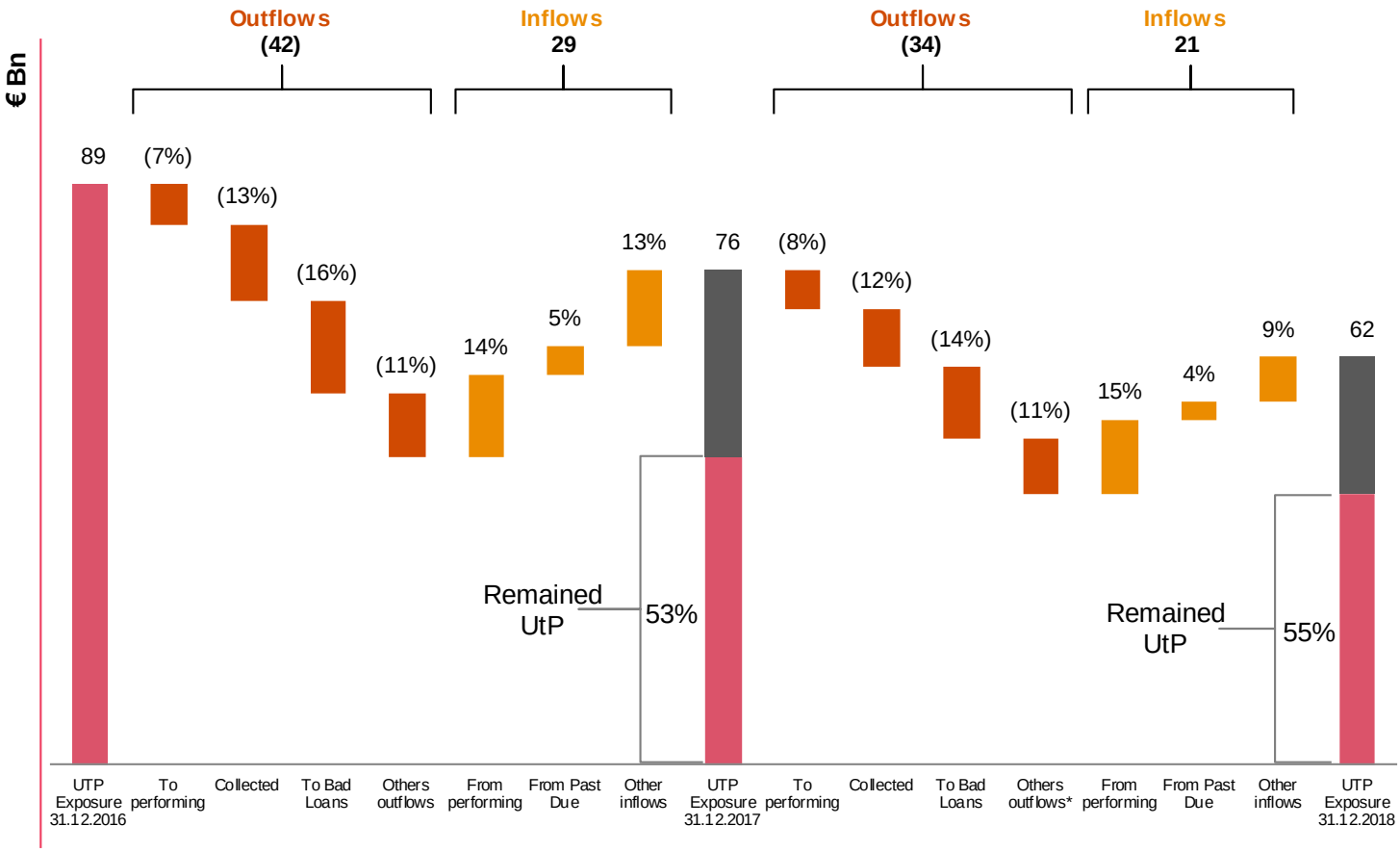
In 2018, the net decrease of gross UtP exposure among top 10 Italian banks remained stable at - €13bn.

Inflows in 2018 decreased from €29bn to €21bn, mainly due to lower "other" inflows and stable inflows from performing and Past Due exposures if calculated as percentage of previous year's UtP stock.

In particular, UtP gauged a firm decline of outflows to bad loans over the last 2-year period: 14% in 2018 vs 16% in 2017.

UtP which remained as such at 31 December 2018 amounted to €41bn (i.e. 55% out of €76bn reported at the end of 2017), proving how the main issue for the Italian UtP lies mainly in their massive stock and a management not yet able to target deleverage solutions.

$$\% \text{ flows} = \frac{\text{UtP In/Outflow}}{\text{Initial UtP exposure}}$$



(*) Including the IFRS 9 transition effect
Source: PwC analysis of banks' financial statements as of Dec 2016-18

UtP performance from 2015 to 2018

Collections and returns to performing

UtP collections and returns to performing, even though the figures remain low, improved from 2015 to 2018. Only through proactive management of UtP, cure rates and collections will further improve

Performance top 10 vs Italian banking market

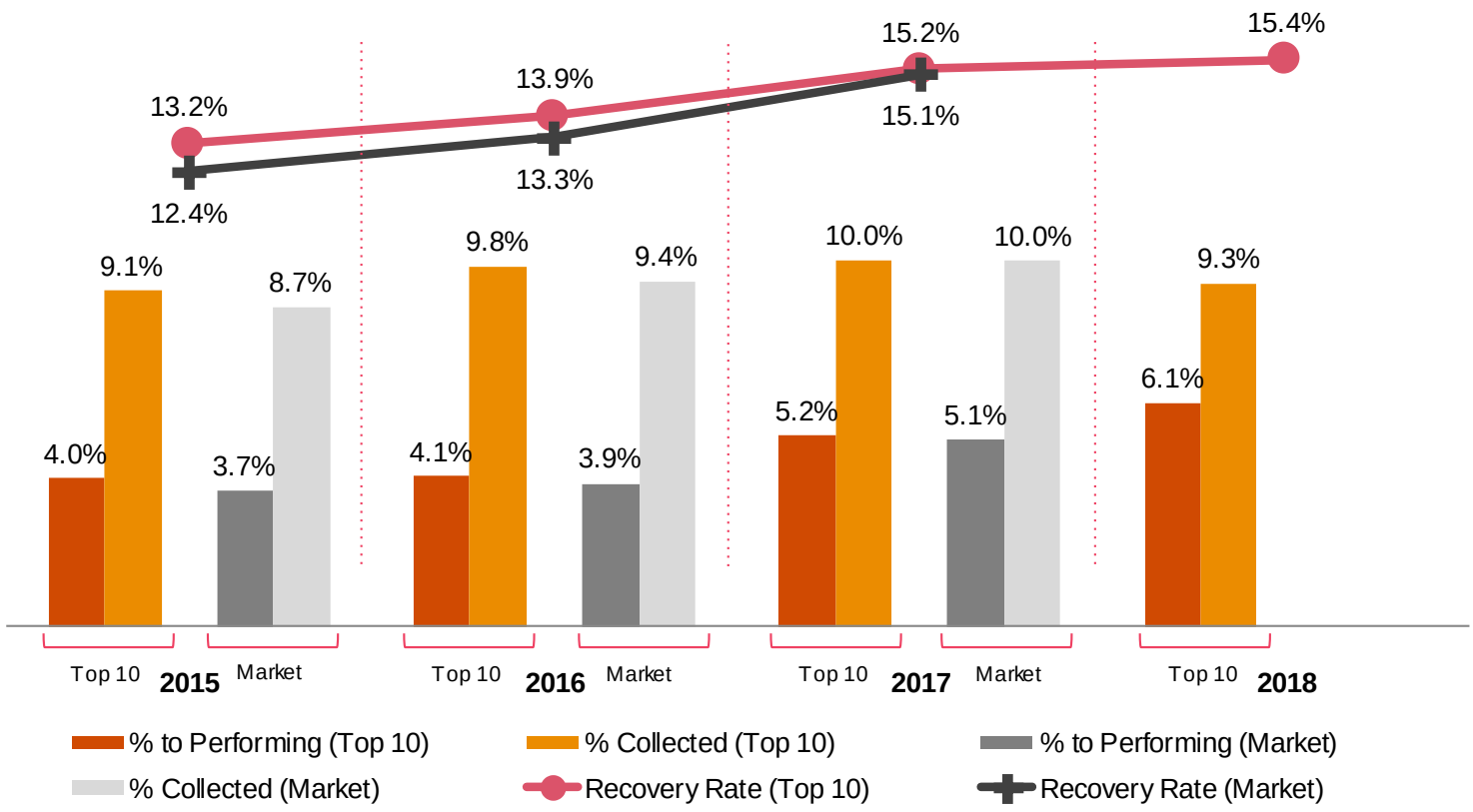
Among the top 10 Italian banks, the portion of UtP returned to performing experienced a positive trend from 2015 (4.0%) to 2018 (6.1%).

A similar trend for the cure rate was confirmed even for the Italian banking market (3.7% in 2015 vs 5.1% in 2017).

Collections of UtP slightly increased over the period 2015-18 from 9.1% to 9.3% (peaking at 10% in 2017).

In general, top 10 banks outperformed the overall market, both in cure rates and collections.

$$\text{Recovery rate (\%)} = \frac{\text{UtP Exit to performing} + \text{Collections}}{\text{UtP Initial exposure} + \text{Inflows}}$$



Sources: PwC analysis of banks' financial statements as of Dec 2015-18, and of data provided by ABI «Associazione Bancaria Italiana»

7.

Deep impact of recent regulatory changes on UtP management

Latest regulatory updates target specific clusters of the NPE world (e.g. secured NPE, forborne exposures, securitisation involving "still-active" borrowers). Many of these changes have been significantly affecting UtP management across UtP value chain: from classification to recovery.

ECB & Bank of Italy

- **Bank of Italy**: update of the Circular 285, focused (among others) on the identification of the correct deleverage strategy of Real Estate properties in terms of timing and economic benefit
- **ECB:** minimum coverage ratios on existing banks' NPE stock should be applied from 2020 onwards (banks will be distinguished in three groups on the basis of their current coverage ratios and Gross NPE ratios). A potential application to LSI is under discussion

Accounting standard setters (IFRS 9)

- Entered into force on January 1st 2018, IFRS 9 introduced an "early-warning and forward-looking approach" to credit risk impairment, resulting in the classification of many bank loans in higher risk categories
- Banks will be required to accrue provisions on the basis of expected losses instead of incurred losses

European Authorities

- **EU Commission:** Calendar Provisioning published on April establishes a 100% provisioning within 8-10 years for secured NPE and within 4 years for unsecured NPE
- **EBA**: Final Guidelines on NPE management requiring banks to accelerate NPE reduction plans and introduce dedicated governance and operational standards

Lawmakers

- **Decreto Crescita:** published on April 2019 and waiting for Parliament's approval, it introduces public guarantee on SMEs financing (also in the form of bond issues) and designs new securitisation solutions for exposures on "still-active" borrowers
- **EU Regulation for a new Securitisation Framework:** entered into force in 2019, it establishes a more risk-sensitive set of rules about complex financial products

8.

“Decreto Crescita»: proposal of new measures to manage SMEs financing and UtP securitisation

The so-called “Decreto Crescita” (“Decree for Growth”) currently waiting for Italian Parliament’s approval, introduces new measures that could be easily applicable to the management of UtP, such as public guarantees on lending to SMEs, public aid on new financing and new securitisation rules.

New insights from the “Decreto Crescita” potentially applicable to UtP market

	Content of the Decree	Potential application to UtP market
1 **Public guarantee on SMEs financing**	Public guarantee on lending to SMEs larger than €2.5mln and expiring in 10+ years (max. coverage: €3.5mln)	Possibility of obtaining public guarantee on new lending to SMEs
	Public guarantee on “mini-bonds” issued by SMEs with less than 500 employees	Public guarantee aimed at supporting refinancing provided by non-bank investors (e.g. private equity funds), even in case of structured deals where securitisation is necessary in order to raise funds from institutional investors
	Public guarantee on ABS issued in the setting of a bond securitisation (traditional or synthetic)	
2 **Public aids to SMEs financing**	Increase of the maximum ticket size applicable to public aid on loans to SMEs, from €2mln to €4mln	Possibility of obtaining public contribution on new financing to borrowers
3 **New securitisation rules**	NPE securitisation scheme that allow banks to provide new financing	New approach that could enable the securitisation of exposures related to still-active borrowers (i.e. UtP)
	Improvement of Real Estate assets’ remarketing through secondary SPV(s) in charge of managing and disposing asset	More flexible and tax-free management of secured exposures when conditions for collateral seizing / leased assets’ repossessing are met (liquidation scenario)
	Tax neutrality if repossessed collateralized assets are disposed within 5 years	

9.

How has IFRS 9 affected UtP?

Starting from FY 2018, a different classification and valuation approach (from "incurred" to "expected" losses) established by IFRS 9 significantly affected credit risk reserves since large portions of loans' portfolios have been reclassified under higher-risk categories. Moreover, the use of disposal scenarios by banks further impacted impairment losses.

Our view on the requirements stemming from the adoption of IFRS 9 by Italian banks

The transition to IFRS 9 (from IAS 39) has been critical as banks are now required to accrue provisions based on expected losses and not only upon the occurrence of specific events (e.g. "impairment tests"). Banks are asked to adopt a "forward looking" approach and as such to anticipate losses at the first signals of deterioration.

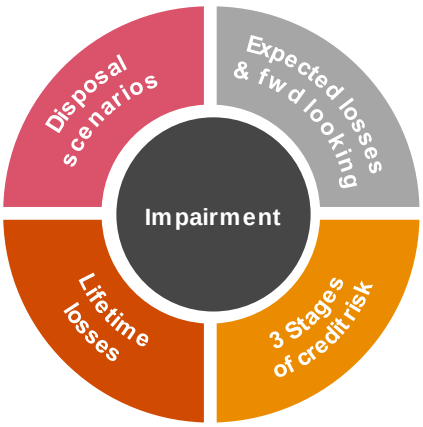
As a result, specific instruments as well as right structure and skilled people to proactively monitor borrowers' performances are required.

Business model

Cash flow model	Hold to collect	Hold to collect and sell
1 Solely payment of principal and interests	Amortised cost	FV through OCI
2 Presence of different cash flows, other than principal and interests	FV through P&L	FV through P&L
	for the "portfolio to hold", banks are strengthening internal credit monitoring functions as well as renewing credit risk measurement tools (e.g. KPI, index, advanced CRM solutions)	for the "portfolio to sell", banks are implementing specialised units in charge of structuring and executing loan sale transactions (e.g. data preparation and remediation, securitisation)

Measurement

Impairment drivers under IFRS 9



Expected losses and forward-looking approach
Certain portions of the current portfolio have been classified in loans' higher risk categories (e.g. from performing to UtP / Bad Loans)

3 Stages of credit risk
Credit exposures must be classified under 3 Stages (where: Stage 1 = performing, Stage 2 = significantly increased credit risk and Stage 3 = non performing)

Lifetime losses
Banks are required to implement proactive actions to preliminarily assess borrowers' likelihood to pay along with avoiding further increase of the danger rate from Stage 1 to Stage 3

Disposal scenarios
The use of valuation scenarios in which banks assume to quickly dispose their NPE had a significant impact on impairment losses

10.

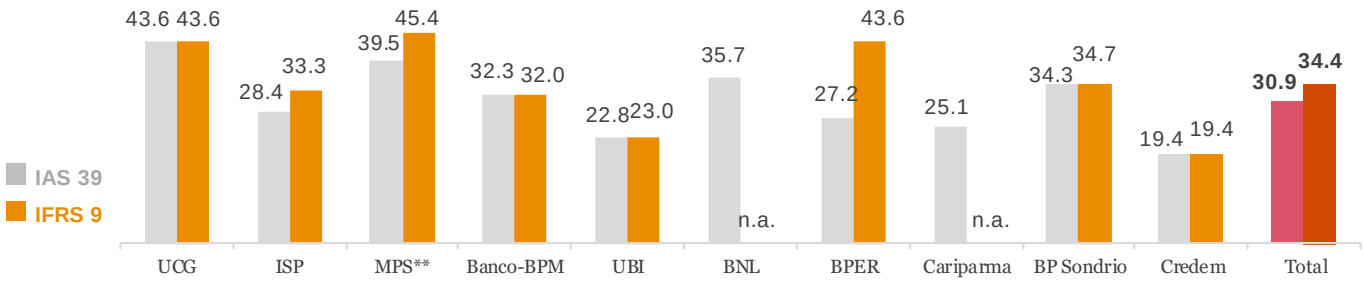
IFRS 9 has significantly affected UtP and Bad Loans coverage levels

With the adoption of IFRS 9 top 10 Italian banks have been increasing their UtP and Bad Loans coverage ratios, reaching 34.4% and 67.4% on January 1st 2018 respectively (vs 30.9% and 61.8% as of December 2017), mainly driven by the inclusion of disposal scenarios in valuation methodology.

Chart 29: Top 10 Italian banks – UtP Coverage Ratio before and after IFRS 9 adoption

Data as of 31/12/2017 for IAS 39 and as of 1/1/2018 for IFRS 9 in %

	UCG	ISP	MPS**	Banco-BPM	UBI	BNL	BPER	Cariparma	BP Sondrio	Credem	Total
IFRS 9 impact* [€m]	n.a.	852	494	(137)	(44)	n.a.	545	n.a.	6	-	
Δ IFRS 9 vs. IAS 39	-	+4.9	+5.9	(0.4)	+0.2	n.a.	+16.4	n.a.	+0.4	-	**+3.4**

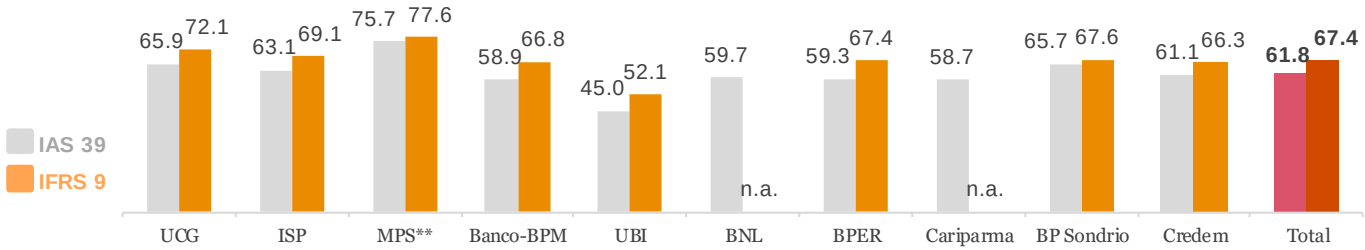


Sources: PwC analysis on financial statements and analysts' presentations. Rounded numbers, total as simple average of ratios
Note: (*) Calculated as the difference between IFRS 9 and IAS 39 provisions (gross of tax effect). Such amount might be affected also by IFRS 9 reclassification effect; (**) data as of 1Q18 for MPS

Chart 28: Top 10 Italian banks – Bad Loans Coverage Ratio before and after IFRS 9 adoption

Data as of 31/12/2017 for IAS 39 and as of 1/1/2018 for IFRS 9 in %

	UCG	ISP	MPS**	Banco-BPM	UBI	BNL	BPER	Cariparma	BP Sondrio	Credem	Total
IFRS 9 impact* [€m]	n.a.	2,063	649	,246	513	n.a.	575	n.a.	33	43	
Δ IFRS 9 vs. IAS 39	*+6.2*	*+6.0*	*+1.8*	*+7.9*	*+7.0*	*n.a.*	*+8.1*	*n.a.*	*+1.9*	*+5.3*	***+5.5***



Sources: PwC analysis on financial statements and analysts' presentations. Rounded numbers, total as simple average of ratios
Note: (*) Calculated as the difference between IFRS 9 and IAS 39 provisions (gross of tax effect). Such amount might be affected also by IFRS 9 reclassification effect; (**) data as of 1Q18 for MPS

UtP: «Tailor made» solutions aimed at a proactive management to improve banks' asset quality

Banks have to tackle the UtP challenge, carrying on portfolio segmentation to move them out of their hybrid status, as well as implementing a due diligence approach on a single-name basis to identify the optimal deleveraging strategy

Overview of the UtP management process

Analysing and **clustering** UtP exposures

Desktop analysis / due diligence of the overall UtP portfolio in order to:

- Set up **credit databases** aimed at collecting and processing data on single credit lines and borrowers
- Define a proper **portfolio clustering**
- Identify borrowers to be managed on a single-name basis

Internal workout vs **servicing**

Strategic drivers for the outsourcing of UtP management:

- **Portfolio features** (and presence of market players able to manage it)
- Banks' **industrial capacity** and **know-how** in managing restructuring processes
- **Regulators'** influence

Assessing the opportunity of a **true sale**

Deciding whether to dispose (and derecognise) a UtP depends on some key factors such as:

- Banks' capital requirements
- Regulators' influence
- **Need of improving asset quality**
- Willingness to take a bet on **potential upside opportunities**

Identifying the **potential return to performing** (going vs gone concern)

- Directly interact with borrowers in order to "test the water"
- Analysis of information available on credit files and public sources
- Regularly monitor the **Central Credit Register**

Determining the proper **credit recovery strategy**

- **Gone-concern approach** (liquidation scenario): set up judicial proceedings
- **Going-concern approach**: monitor ongoing restructuring processes and/or promote new solutions (e.g. bilateral negotiation of rescheduling / debt forgiveness agreements)

Providing **new financing** as possible way out of crisis

- **Senior lending** (traditional corporate lending provided by originator banks on the basis of restructuring agreements)
- **Structured financing solutions** (use of Restructuring Fund, DIP Financing, synthetic securitisation)

12.

A UtP portfolio is a complicated asset class and needs to be properly understood for a proper management

The challenge of UtP management is not only about their magnitude (€79bn of GBV) and their "fixed" stock (55%), but it also concerns their intrinsic complexity as an asset class.

Clustering the UtP exposures

Not all UtP exposures are equal. According to Bank of Italy, UtP are classified as such according to the judgment of the banks about the debtor's unlikelihood to fulfil its credit obligations.

As a result, UtP category may include, on one hand borrowers featuring overdue instalments (similar to Past Due exposures) and, on the opposite hand borrowers whose critical financial situation could lead easily to the status of Bad Loans.

Between these two sub-categories UtP include all exposures involved in some kind of restructuring measures.

Moreover, UtP are different depending on borrower's characteristics, such as ticket size, vintage (from how long the exposure is classified as UtP) and loan's features (e.g. available guarantees, type of collateral, type of credit facility).

Each of these features must lead to a specific managerial strategy. Therefore, the punctual comprehension and correct clustering of a UtP portfolio is essential for its proper and effective management by Italian banks.

Type of UtP \ Type of borrower	Industry	Size	"Vintage"	Collateral
"Overdue" UtP	✓	✓	✓	✓
"Restructured" UtPs (subj. to extrajudicial agreements such as recovery plans ex art. 67 & art. 182bis Italian Bankruptcy Law, as well as other restructuring procedures)	✓	✓	✓	✓
"Non performing" UtP (Almost Bad Loans)	✓	✓	✓	✓

13.

Which strategic options are available to fix the UtP issue?

UtP require a "tailor-made" approach to credit recovery. Following the improved proactive management pushed by the Regulators, banks could identify the most effective and efficient solutions to deleverage their UtP (e.g. return to performing, collection) among several strategic options.

Our view on the available strategies for UtP

Strategic options identified through the due diligence carried out by banks on their borrowers' cases could result in the return to the performing category through the implementation of internal forbearance measures, in the loan disposal or in the classification as Bad Loans (thus requiring the prompt liquidation of the borrowers' collateral assets through judicial proceedings).

Sale of UtP could be even executed through portfolios transactions which require preliminary strategic segmentation to maximise loan value for the banks.

Otherwise, banks may decide to outsource the management of NPE (such as UtP) to a specialised credit servicer.

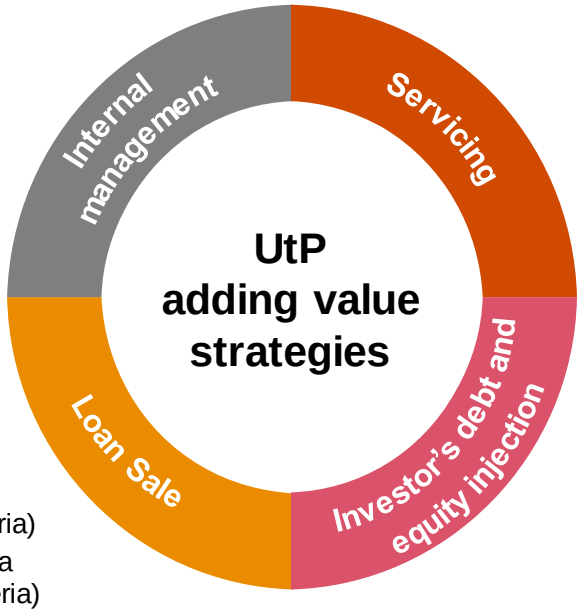
Moreover, in case of potential return to performing, it is important to consider new financing as possible way out of crisis.

Internal management

- Forbearance measures:
  - Grace period/Payment moratorium
  - Extension of maturity/term
  - Debt consolidation
  - New credit facilities
  - Recovery plan by Italian Bankruptcy Law (e.g. art. 67 & 182 bis)
- Segmenting by industry/ type of UtP (overdue, restructured or defaulted)

Loan sale

- True sale/securitisation
- Single names' sale on a best offer basis (opportunistic criteria)
- Single names' sale based on a structured plan (strategic criteria)
- Sale of UtP portfolios, usually clustered based on ticket size, type of loan / guarantee (e.g. leasing vs mortgage loans) or type of collateral asset



Servicing

- New opportunities of value creation
- Mandatory will be the transition from standardised approaches applied to Past Due and Bad Loans management to tailor-made solutions for UtP
- It is necessary to consider the possibility of providing new financing to borrowers based on their recovery plans

Investor's equity injection/ underwriting of senior debt

- Industrial partner to revamp and establish the underlying borrower's business (long term approach)
- Financial partner to inject cash within a strategic exit plan (short/medium term approach), even using structured financing solutions

Strategic drivers leading banks' decisions on UtP management

Banks should opt for internal / external management of their UtP exposures depending on who is the player that really has industrial capacity and expertise to apply tailor-made solutions. Moreover, banks have the possibility to sell UtP in order to improve asset quality in the short-mid term.

As discussed in the previous page, there are four different possibilities of managing UtP exposures. These options imply the true sale (derecognition), a mandate given to a servicer or the internal workout carried by the originator bank.

The decision of retaining or selling UtP portfolios/ single names (and, if retained, the choice between internal and external management) will be driven by several strategic drivers, entailing regulatory requirements, accounting standards, banks' industrial capacity and expertise, long-term vision of their NPE management.

Deleverage options

Keep UtP on books | **Loan sale**

Strategic drivers

- Capital requirements
- Financial Statements overhaul following UtP derecognition
- Regulators' influence (ECB, Bank of Italy, EBA)
- Presence/absence of upside opportunities for the bank (following the restructuring measures)
- Bank's long-term strategic objectives about their NPE management

Type of UtP

"Overdue" UtP

"Restructured" UtPs
(subj. to extrajudicial agreements such as recovery plans ex art. 67 & art. 182bis Italian Bankruptcy Law, as well as other restructuring procedures)

«Non performing» UtPs
(almost Bad Loans – to be valued using a gone-concern approach)

Management options

Internal mgmt | **Servicing**

Strategic drivers

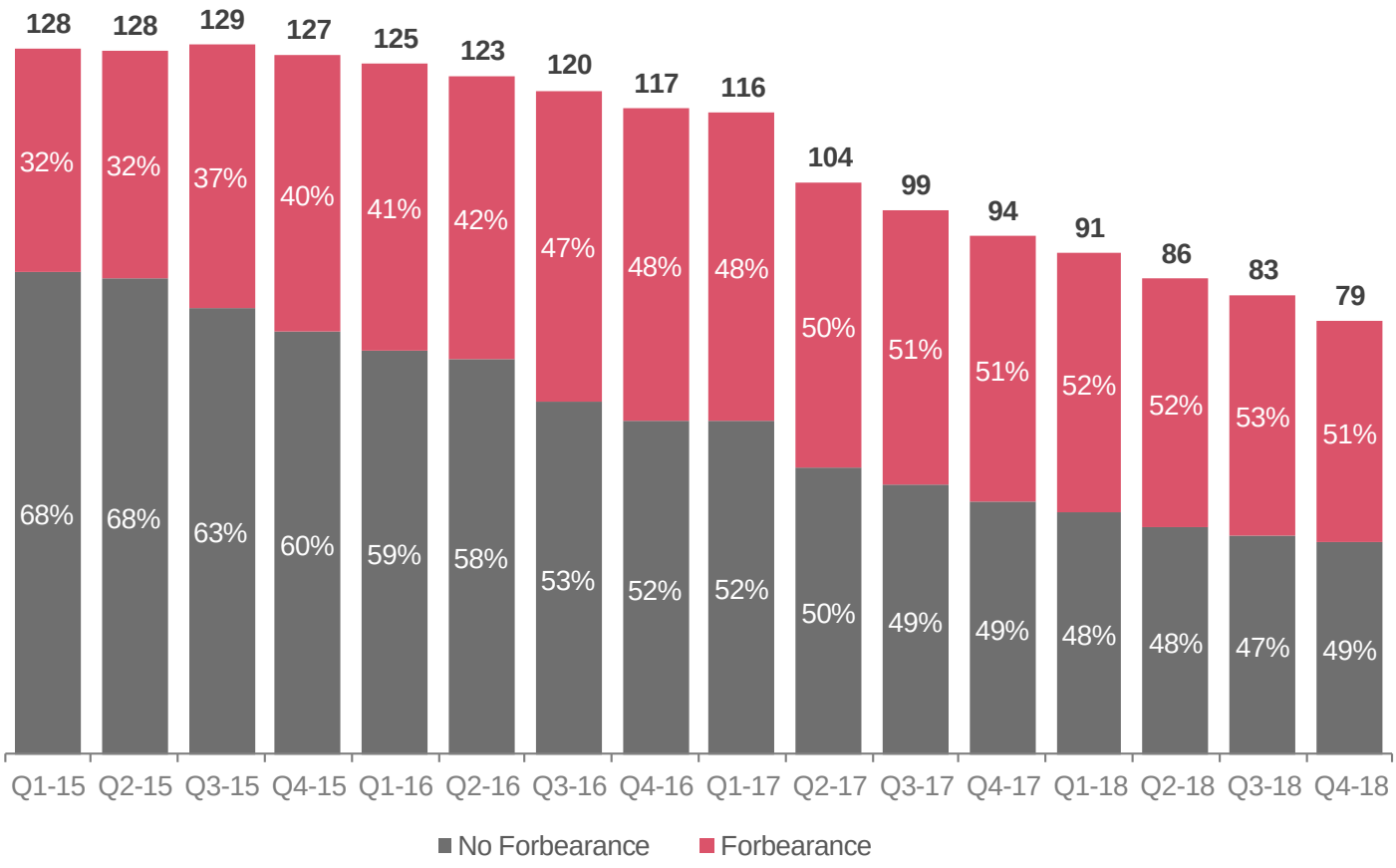
- Portfolio features (borrower size, industry, "vintage" in bank's balance-sheet, presence of guarantees, revolving vs. term loans etc.)
- Bank's expertise in managing restructuring processes
- Capability of third-party players to provide a fully-integrated approach to credit management (due-diligence, restructuring, refinancing)
- Bank's industrial capacity in proactively managing massive stocks of UtP
- Regulators' influence (ECB, Bank of Italy, EBA)

Forbearance measures' trend from 2015 to 2018

Despite the decline in UtP of approx. €50bn from Q1-2015 to Q4-2018, exposures subject to forbearance measures are approximately the same (€40bn). In fact, the proportion of forborne exposures has increased over time: forbearance ratio peaked at 53% in Q3-2018 (vs. 32% in Q1 2015).

Italian banks' forborne UtP exposures (€ bn)

$$\text{Forbearance Ratio} = \frac{\text{Forborne UtP exposures}}{\text{Total UtP exposures}}$$



Source: Bank of Italy Report – «Condizioni e rischiosità del credito» updated Dec 2018

The heterogeneous world of NPE servicing

The NPE servicing world is populated by a wide range of players, often structured in different legal forms (e.g. banks, intermediaries ex art. 106 or 115 Italian Banking Law) and focused on specific segments of the NPE market.

NPE market and its actors

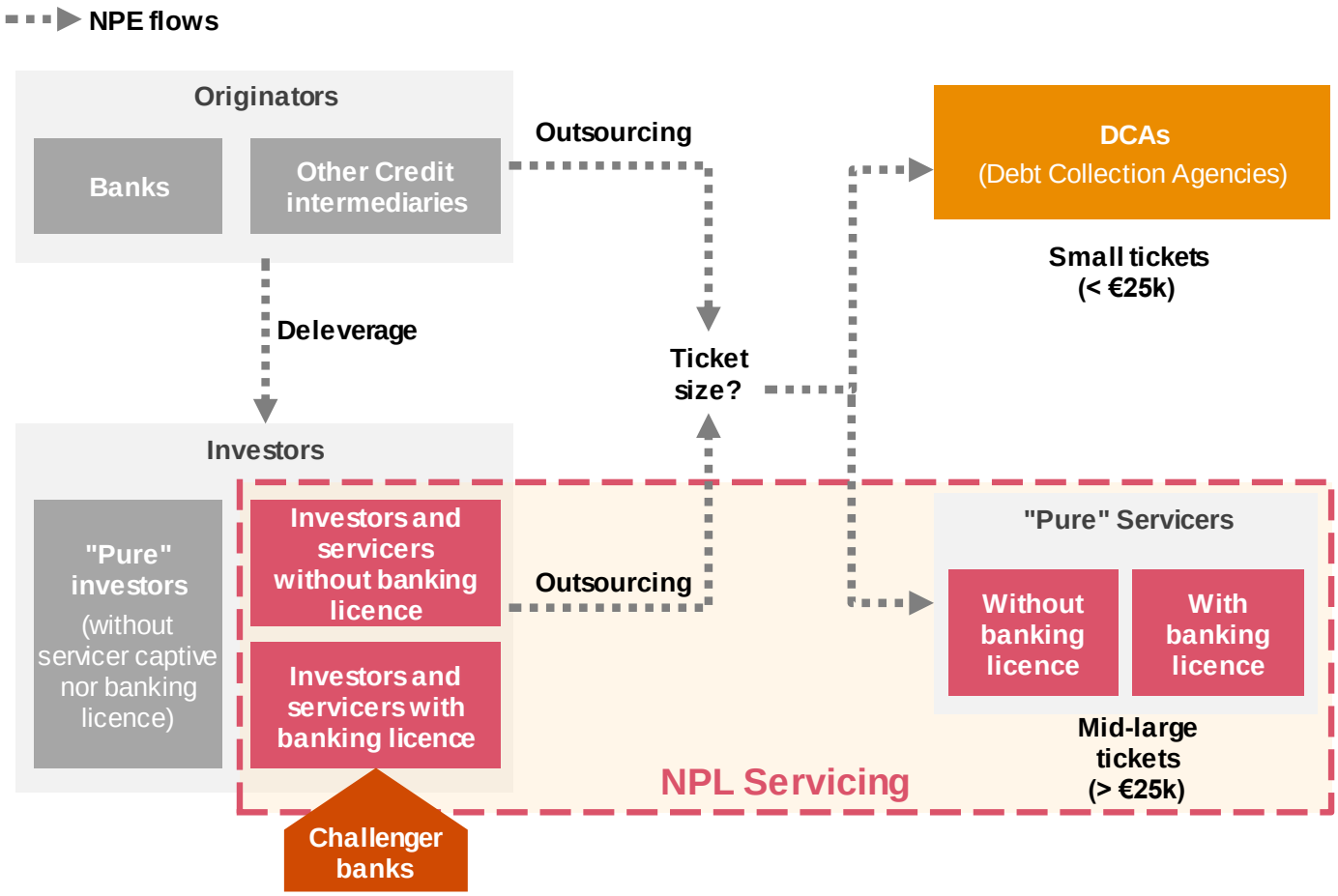
Recent NPE market evolution has guaranteed the possibility to dispose a significant portion of banks' NPE portfolios.

Investors acquiring NPE might be pure investors with no captive servicer incorporated or "servinvestors" able to perform credit recovery activities and, in some cases, qualified as banks (such as the so-called "challenger banks").

If originator banks or investors opt for outsourcing NPE, many different players might be engaged.

Usually, small exposures (e.g. below €25k) are committed to DCAs (Debt Collection Agencies, normally organised as intermediaries ex art. 115 Italian Banking Law), connected with several private players specialised in home and phone collection. All other exposures are committed to NPL Servicers, sometimes acting with banking license.

As widely discussed, UtP need a tailor-made approach and require significant know-how in managing restructuring processes. Which player will be the winner of UtP challenge?



17.

Who are today's players able to effectively manage UtP?

UtP is a complicated asset class to deal with: the best management solution requires the capacity to combine tailor-made recovery strategies (depending on single-names' and portfolios' features) with a lean and flexible operating model.

Traditional NPE servicing and UtP

Because of the complexity of UtP asset class, it requires high flexibility in determining credit recovery strategy. To this extent, many different skills should be applied depending on portfolio (single-name) characteristics.

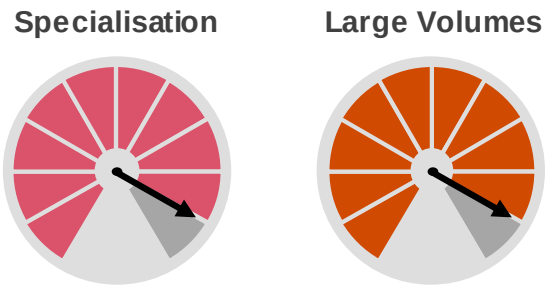
For instance, ongoing restructuring agreements should be correctly assessed and managed and the need of new financing should be further addressed within the new plans; likewise, collateralised exposures require Real Estate capabilities if conditions for asset's repossessing are met.

Nowadays' credit servicing industry has been moving towards more specialised business models based on managed portfolios' characteristics (mainly: stage, size and presence of collateral).

In this panorama, considering the continuing evolution of the UtP market, will NPL servicers and / or challenger banks be able to undertake the challenge of systematically manage UtP exposures? or will UtP management depend on the adoption of very specific business models that fall outside the trade-off between NPL Servicing and challenger banks?

Optimal management solution combines specialisation and large volumes

Evolution of the NPE Servicing market will be determined by how players will be able to get one step ahead of their competitors. Nowadays' market requires two breakthrough characteristics that a servicer must combine to be a top ranked: **specialisation and large volumes**.

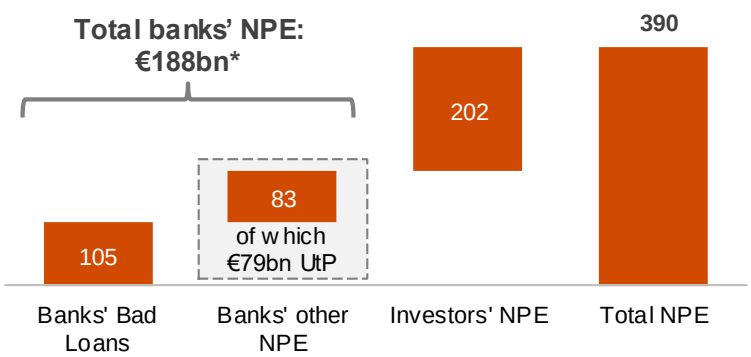


		Sub-performing e Past-Due	UtP	Bad Loans
Small tickets	Unsec	- DCA (early collection services)	? NPL Servicer and / or Challenger Banks?	DCA
	Sec	- Banks		DCA, NPL Servicer and Real Estate
Mid / Large tickets	Unsec	Banks		NPL Servicer
	Sec			NPL Servicer (frequently with the support of Real Estate)

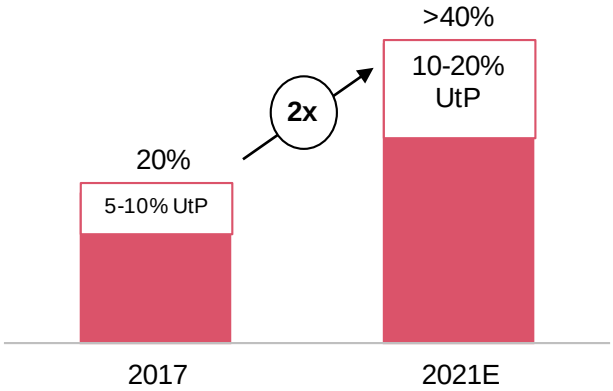
Servicing of UtP as a new market opportunity

Outsourcing UtP is the new frontier of NPE servicing. Specialised servicers must migrate from a traditional management of overdue UtP exposures to a proactive management of UtP, thus entailing new lending and restructuring measures as strategic management options.

Total Gross NPE in Italy
Values in €bn



% of NPE stock outsourced to specialists



(*) Different from €180bn reported by Bank of Italy because it includes Bad Loans in financial intermediaries ex art. 106 Italian Banking Law and excludes Bad Loans acquired by challenger banks.

Conditions to be satisfied by the Servicers for the management of UtP

Management – Servicers must carry on a proactive management of UtP borrowers on a daily basis. Essential is the relationship established with the borrowers and the knowledge of their local market.

New lending – Through the ongoing management of existing loan contracts, servicers must secure: 1) new injection of cash (debt and/or equity) into the UtP borrowers' capital structure, including working capital facility, directly (e.g. challenger banks) or indirectly (through third party investors) and 2) support in defining restructuring plans.

IT Platform – Servicers must migrate the UtP management on advanced IT platform aiming at promptly managing the relevant information about borrowers.

UtP servicing market: today's key players

Today's UtP servicing market is characterised by few players (who can be considered as "first movers") representing almost 100% of total GBV under management. Being UtP servicing an emerging market, we expect that these figures will significantly change even in the next future.

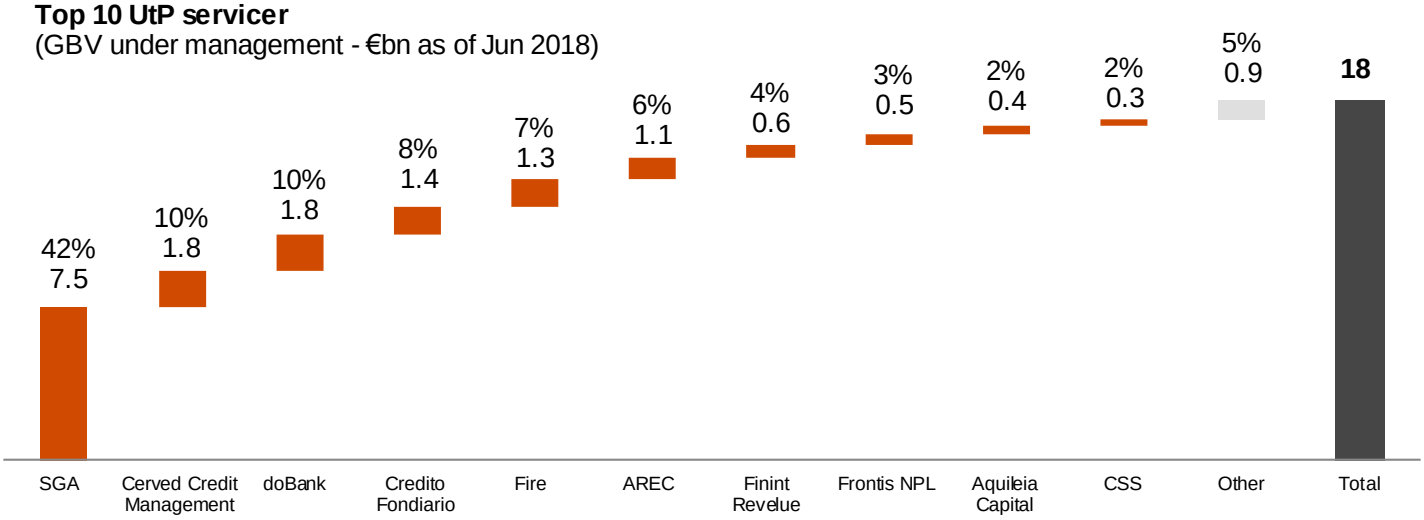
UtP servicing: an emerging, fast-moving market

Figures shown in the chart below explain the first paces of the emerging UtP servicing market. First of all, the size of top 10 players is much smaller than the one of top 10 Bad Loans servicers: €16.8bn versus €171bn respectively.

UtP servicing market is also more concentrated than Bad Loans' one: UtP managed by top 10 players represents around 95% of total UtP servicing market, while top 10 Bad Loans servicers cover around 73% of their market.

Furthermore, the estimated ratio between UtP under management and UtP held by banks is approx. 19%*, while the same ratio calculated on Bad Loans is circa 80%*. This evidence shows that there is room to take the UtP serving challenge seriously.

Top 10 UtP servicer
(GBV under management - €bn as of Jun 2018)



	Top 10 servicers' AuM (GBV)	Total market AuM (GBV)	Top 10 AuM vs market	AuM / GBV held by banks and investors*
UtP	**~€16.8bn**	**~€18bn**	**~95%**	**~19%**
Bad Loans	**~€171bn**	**~€230bn**	**~73%**	**~80%**

Source: PwC analysis on data provided by Servicers as of Jun 2018 and other public information. Data have been directly provided by Servicers and have not been verified by PwC. Servicers present highly heterogeneous organisational, industrial and operating structures: comparing the information presented above requires a correct analysis and understanding of the competitive landscape and servicers' business models
Notes: (*) Considering the overall amount of UtP and Bad Loans owned by banks and investors, as reported in the previous page (assumption: current UtP stock is equal to €79bn held by banks plus circa €14bn held by investors).

UtP portfolios / single-names transactions in 2018 and pipeline for 2019

In 2018 UtP transactions increased in terms of number but, excluding the ones realised in the context of banks' bailouts, have been quite limited in terms of frequency and volumes. Moreover, some banks have announced Jumbo sales for UtP portfolios in 2019.

During 2018, we observed the birth of larger UtP portfolio sales. UtP transactions have mainly involved top-tier banks, and the vast majority concerned Real-Estate secured portfolios.

Major UtP disposal projects have been promoted and closed by MPS, Creval, CA Cariparma, Carige, although other banks have been taking part to this market promoting single-names' and smaller portfolios' disposals.

Main UtP* loan sale transactions in 2018

Project	Gimli-1	Gimli-2	Valery	n.a.	Isabel	Alfa 2
Seller	Creval	Creval	CA Cariparma	MPS	Carige	MPS
Acquiror	Algebris	Credito Fondiario	Bain Capital	Confidential	Bain Capital	Confidential
P / GBV	43%	41%	40%	n.a.	n.a.	n.a.
GBV [€mln]	245	222	450	800	366	400
	2018 Q2	2018 Q2	2018 Q3	2018 Q3	2018 Q4	2018 Q4
Portfolio	Secured	Secured	Mainly Secured	n.a.	n.a.	Secured
Collateral	RE	RE	RE	n.a.	RE	RE

Italian banks have already announced ongoing UtP Jumbo deals for over €15bn

The UtP portfolios' size has been increasing: main announced transactions are going to surpass the €1bn threshold.

In particular, Intesa Sanpaolo announced the deleverage / servicing of a ~€10bn UtP portfolio and UniCredit is carrying on its deleveraging strategy throughout Project Sandokan 2 (~€3bn), whose closing is expected within the following months.

Also MPS and Carige announced ongoing transactions of respectively ~€1.6bn (divided in smaller projects) and ~€0.9bn (part of a larger portfolio including further ~€0.9bn Bad Loans).

UtP deleverage is becoming crucial for Italian banks' asset quality, even more so after that UtP reached and even surpassed the levels of Bad Loans in terms of NBV. Banks now are moving towards differentiated and structured deleveraging strategies.

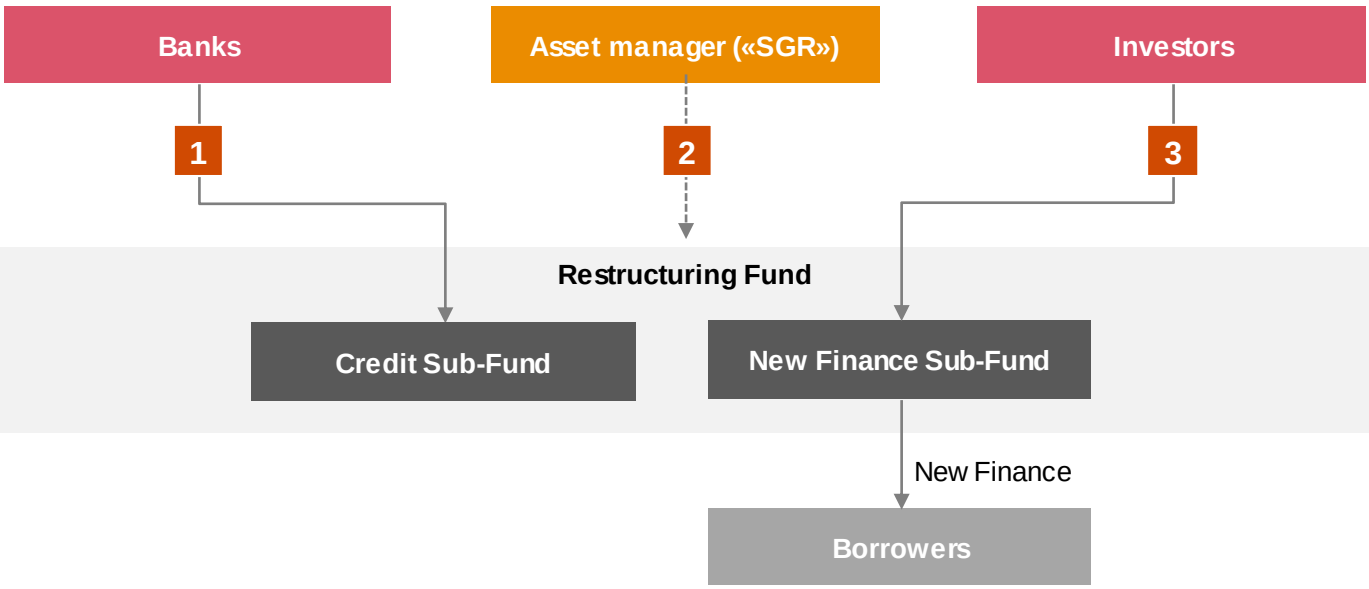
Source: PwC estimates on public information and market rumours. Analysis on loan sale transactions, without considering structured ones, such as restructuring funds and synthetic securitizations
Note: (*) Considering only 100% UtP portfolios and mixed portfolios mainly composed of UtP.

Structured refinancing solutions for UtP (1/4)

Restructuring Fund aimed at deleveraging banks' NPE and providing new financing to UtP borrowers.

Deal structure	Type of investor	Derecognition for the banks
Use of a Restructuring Fund owning two sub-funds: banks securitise NPE in the Credit Sub-Fund, while investors underwrite the New Finance Sub-Fund's notes, which provides financing to borrowers	Private Debt Funds investing in distressed companies	Banks can derecognise the loan and replace it with shares of the investment vehicle / fund

Operating model



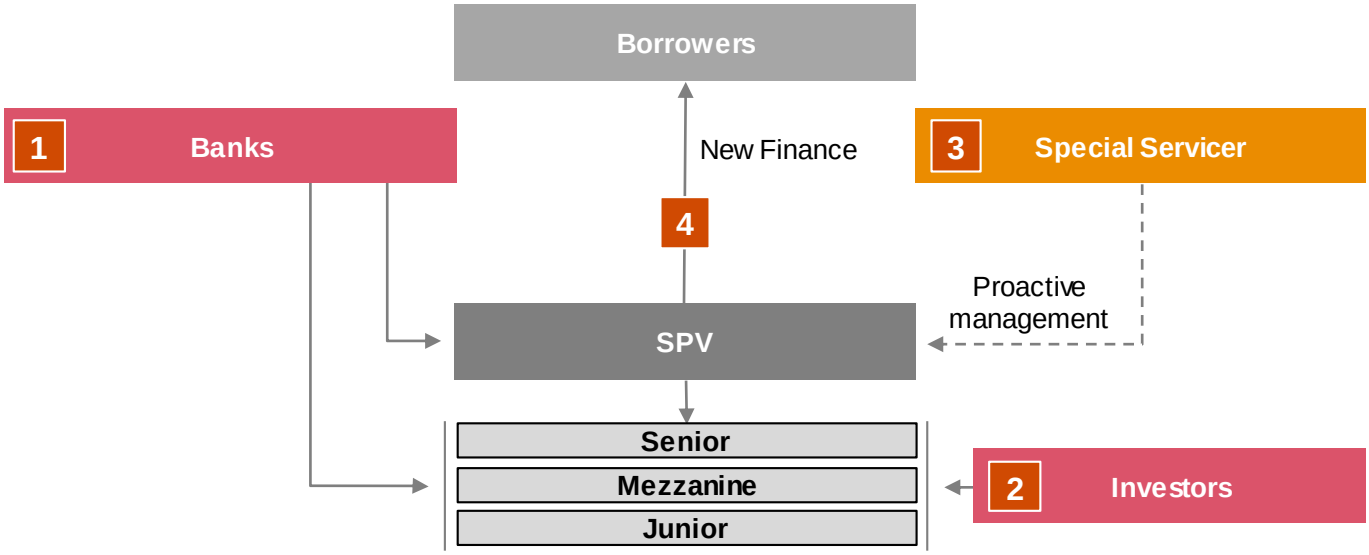
1. Banks transfer their receivables to the Credit Sub-Fund in exchange of related funds' shares
2. Fund management and proactive management of the operations
3. Investment in the New Finance Sub-Fund, in order to guarantee new funding to the borrowers (i.e. super senior financing)

Structured refinancing solutions for UtP (2/4)

Synthetic securitisation of non-performing exposures.

Deal structure	Type of investor	Derecognition for the banks
Synthetic securitisation of non-performing exposures, potentially subject to the GACS mechanism	Acquirers of asset-backed securities (including the banks originators underwriting the SPV notes) along with investors with different risk profile	Banks cannot derecognise the loan if they hold the credit risk through the junior notes of the SPV

Operating model



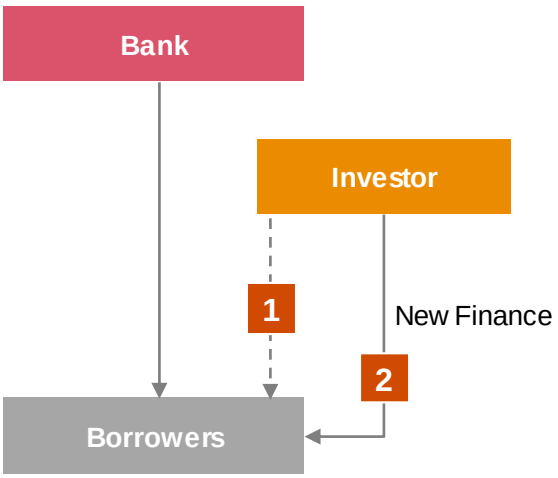
1. Credit disposal to a Special Purpose Vehicle and potential subscription of the notes
2. Subscription of the notes by the investors
3. Proactive management of the company
4. Opportunity for the SPV to provide new finance to the borrowers

Structured refinancing solutions for UtP (3/4)

Acquisition of target company with debtor-in-possession (DIP) financing.

Deal structure	Type of investor	Derecognition for the banks
Acquisition of target company with debtor-in-possession (DIP) financing to realise new investments. Often the investment vehicle/ fund is participated by selling banks	Private Equity Funds (distressed value investing in equity)	Banks can derecognise the loan through a true sale

Operating model



1 Advisory activity towards the borrowers with regard to the turnaround process

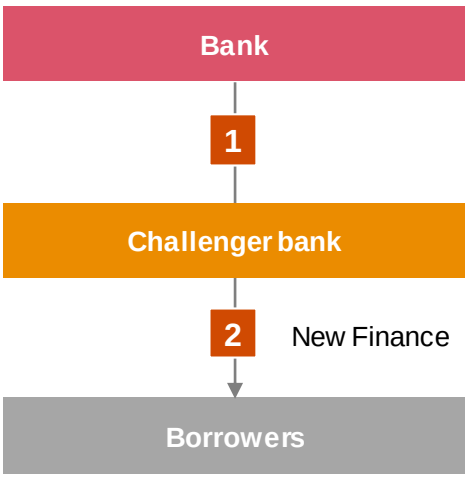
2 Direct investment in the equity of the borrowers and/or new finance provision

Structured refinancing solutions for UtP (4/4)

Challenger banks as financial partners of the traditional banks in the management of their UtP exposures.

Deal structure	Type of investor	Derecognition for the banks
Buyout of single-named UtP aimed at revamping the business throughout provision of new finance to borrowers	Challenger banks	Banks can derecognise the loan through a true sale

Operating model



1 Purchase of the credit from banks and/or grant of new financing along with banks

2 Provision of new finance, also through capital injection

Specialty finance challenger banks: key differentiating factors

The competitive strategy of challenger banks is based on three differentiating pillars: specialisation in high yield segments, distribution model based on alternative channels and digital technology.

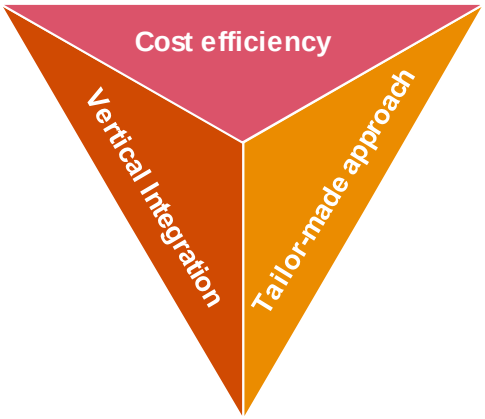
Core elements of Challenger Banks

a Challenger Bank is:

1. Focused on niche segments…
2. … with high yields and / or higher risk
3. Innovative distribution channels…
4. …mostly based on digital technology…
5. …and flexible operating models

	Versus: NPL Servicers	Versus: "Traditional" Banks
Analogies	• Ability to implement soft collection strategies (phone / home collection) and manage judicial proceedings • Realisation of scale economies is proportional to assets under management	• Exposure to the same regulatory, accounting and supervisory framework • Permission to directly provide lending (e.g. super senior financing, working capital facility)
Differences	• Focused on niche segments • Highly skilled in restructuring & turnaround management	• Alternative distribution channels • Broader use of IT technology • Flexible operating models • Investments in higher yield (risk) opportunities

What characteristics should **challenger banks** have in order to play a leading role in the emerging **UtP market**?

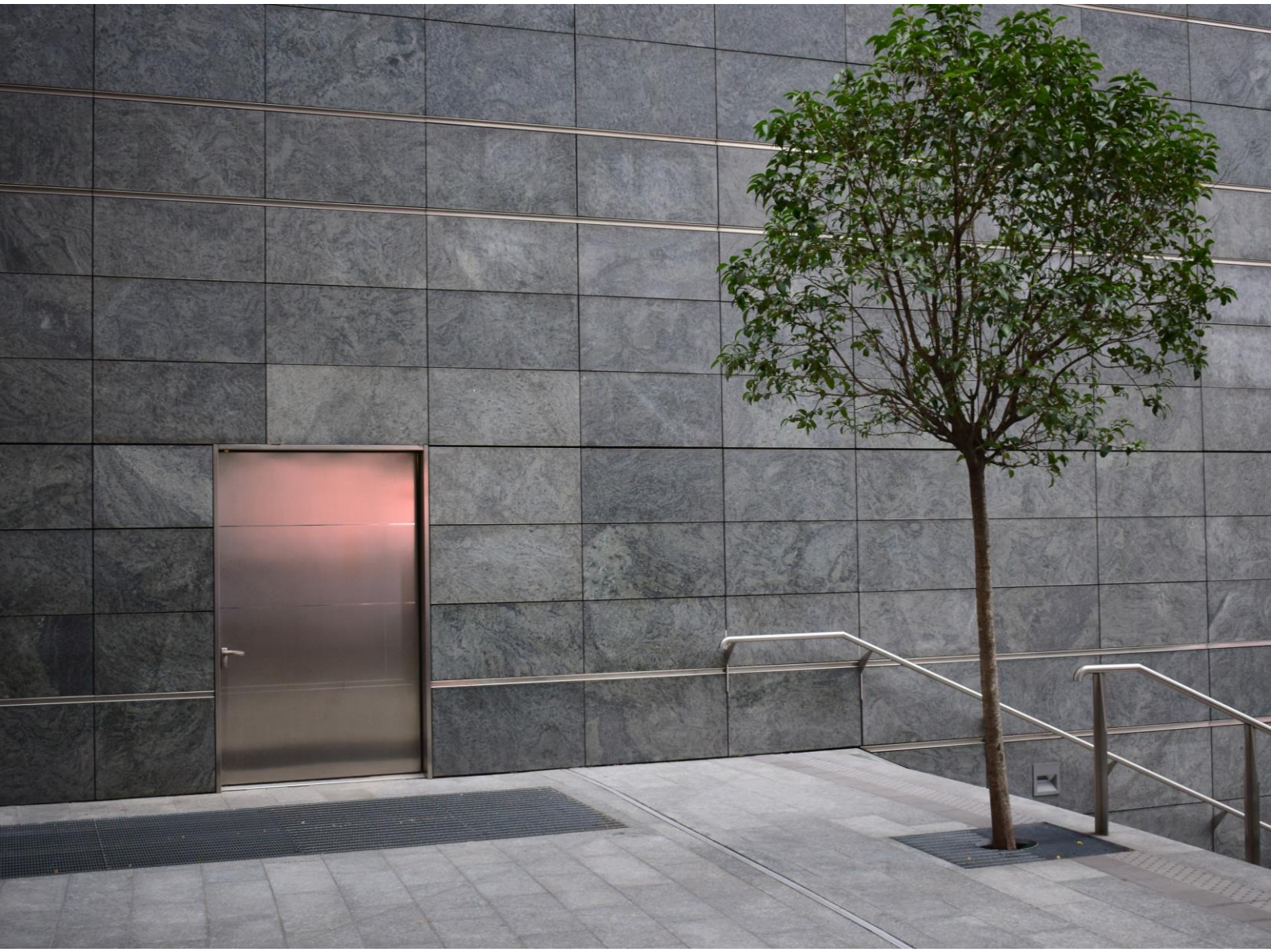


Cost efficiency
Challenger banks' proposal in terms of operational and distribution model should lead to a lean cost structure. Moreover, higher risk-return investments may trigger proportionally lower capital absorption with respect to traditional banks

Tailor-made approach
Players need deep specialisation and knowledge of the counterpart in order to successfully identify and obtain potential upsides from UtP management

Vertical integration
Challenger banks' value proposition also relies on their ability to manage the entire NPE value chain, from the preliminary analyses to the implementation of recovery strategies and (eventually) refinancing


Simon Denny
ECRET POWER
New Zealand
at Venice



Appendix

Non Performing Exposures classifications

How to define and what to include within the "Unlikely to Pay" category.

Non-Performing Exposures

The commonly used term non-performing loans ("NPL") is based on different definitions across Europe.
To overcome problems, EBA has issued a common definition of Non-Performing Exposures ("NPE") which is used for supervisory reporting purposes.

In Italy, banks are also required to distinguish among different classes of NPE: (i) Bad Loans, (ii) Unlikely to Pay and (iii) Past Due; the sum of these 3 categories corresponds to the Non-Performing Exposures referred to in the EBA ITS.

The unlikelihood judgement of UtP

The exposures are classified as Unlikely to Pay in light of the unlikelihood that relevant debtors will fulfil their credit obligations.

The unlikelihood judgement is made by the Bank based on a varied spectrum of signals and issues.

The range of signals and issues may be very wide and differs case by case but a common feature is that each of them is recoverable and/ or is manageable if tackled properly and timely. Time is of essence.

Old	New	Definition of risk category
Past Due Esposizioni scadute > 90 giorni	More than 90 days overdue loans (debt) Esposizioni scadute Including FNPE*	• Exposure to any borrower whose loans are not included in other categories and who, at the date of the balance sheet closure, have Past Due amounts or unauthorised overdrawn positions of more than 90 days • A sub-segment is now represented by the Forborne Non- Performing Exposures ("FNPE"), credits granted to a counterparty in financial difficulty and which are not classified as Bad Loans and have been subject to the modification of the terms and conditions of the contract or refinancing
Restructured Crediti ristrutturati Sub standard Incagli	Unlikely to Pay Inadempienze probabili Including FNPE*	• **The classification of loans in this category is the result of the judgment of the bank about the debtors' unlikelihood to fulfil its credit obligations. This category substitutes the old sub-standard loans ("Incagli") and restructured loans ("Crediti Ristrutturati")** • **A sub-segment of the Unlikely to Pay is now represented by the FNPE**
Bad Loans Sofferenze	Bad Loans Sofferenze Including FNPE*	• Exposure to a borrower in a position of insolvency (not necessarily recognised by a Court) or a substantially similar situation, irrespective of the presence of any collateral. Same as previous classification of Bad Loans or "Sofferenze" • A sub-segment of the Bad Loans is now represented by the FNPE

NPE

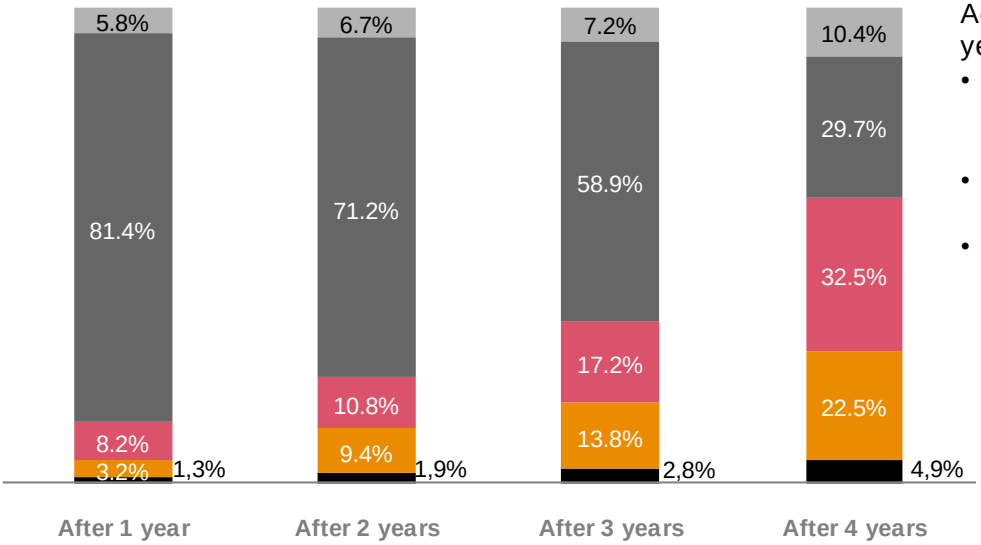
FNPE may become a Forborne Performing Exposure if:
- 12 months have passed from last allowance
- No overdue from last allowance occurred

(*) FNPE: Forborne Non-Performing Exposures
Source: EBA, EBA/ITS/2013/03/rev1 24/7/2014

Forbearance measures and restructuring agreements

Bank of Italy's report shows a lack of effectiveness of the traditional restructuring measures carried out by Italian banks: loans' restructuring procedures should be applied throughout an appropriate and more effective "case by case" analysis of the financial difficulty of the borrower.

Restructured exposures' trend*



According to Bank of Italy, after 4 years:

- 62.2% of restructuring agreements (which qualify most of the UtP exposures) are still in place
- 22.5% resulted in liquidation/bankruptcy procedures)
- 10.4% resulted in a positive and conclusive outcome

- **Financial stability**
- Same procedure
- Other restructuring procedure
- Liquidation/ Bankruptcy
- Extinction/ Incorporation

Source: Bank of Italy – «Questioni di Economia e Finanza» (No. 311, March 2016)

Main forbearance measures** – Application examples

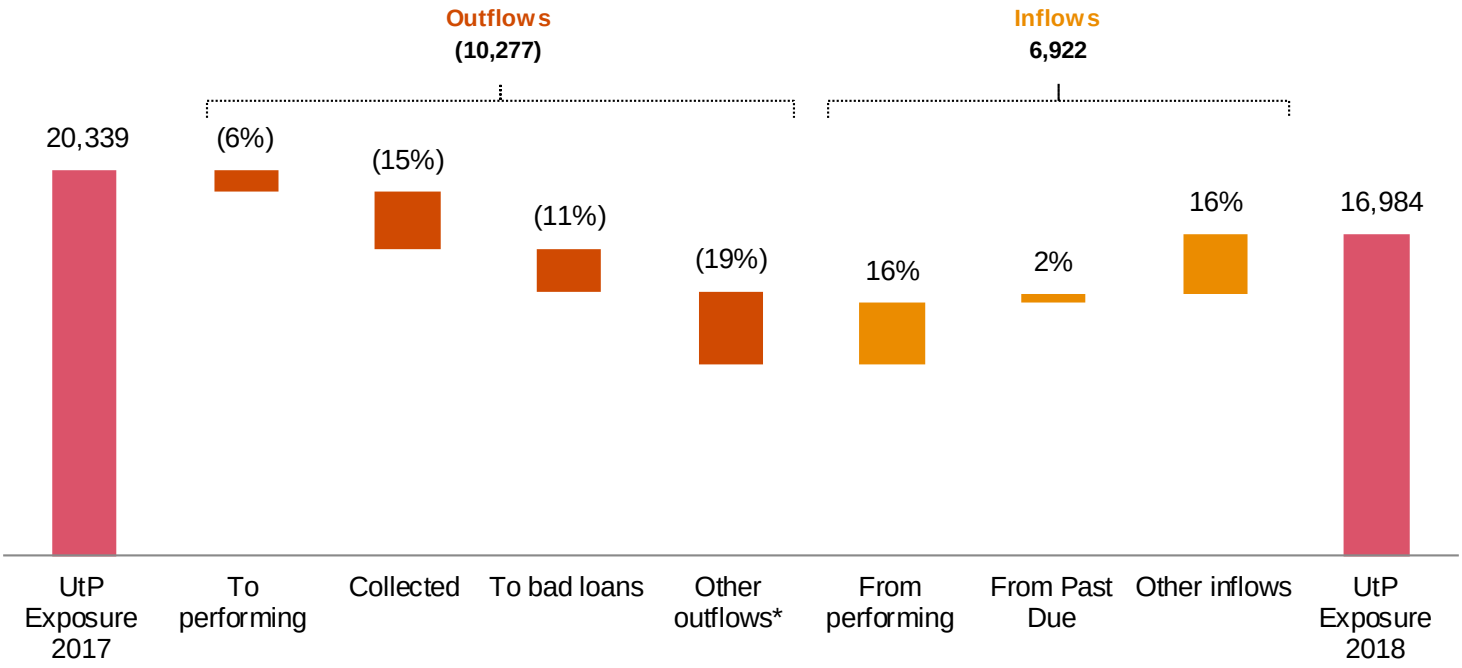
Area of intervention	Adoption of short-term measures		Adoption of long-term measures	
	Financial difficulty	Measure	Financial difficulty	Measure
Interest	• Temporary financial difficulty of minor entity to be overcome within 24 months	• Temporary payment of **interest only** (no capital reimbursement)	• Excessively high interest rates for the debtor	• **Permanent reduction** of interest rates
Instalments	• Temporary financial difficulty of moderate entity to be overcome within 24 months	• **Temporary reduction** of instalment amount • Full interest payment	• Misalignment between repayment plan and reimbursement capacity of the debtor	• **Rescheduling** of amortisation plan (e.g. partial, bullet, step-up)
Maturity	• Temporary financial difficulty of moderate/ serious entity to be overcome within 24 mo.	• "**Grace period**" for the payment of interests and capital	• Excessively high instalments for the debtor	• **Extension** of debt maturity
Collateral			• Permanent difficulty and good level of collateralisation	• **Voluntary disposal of collateral** by the debtor

(*) This trend is related to the years from 2010 to 2014 (restructuring processes begun in 2010). By «Restructured exposures» Bank of Italy refers to exposures subject to the procedures established by the Italian Bankruptcy Law:
(**) In addition to debt forgiveness and/or arrears capitalisation options

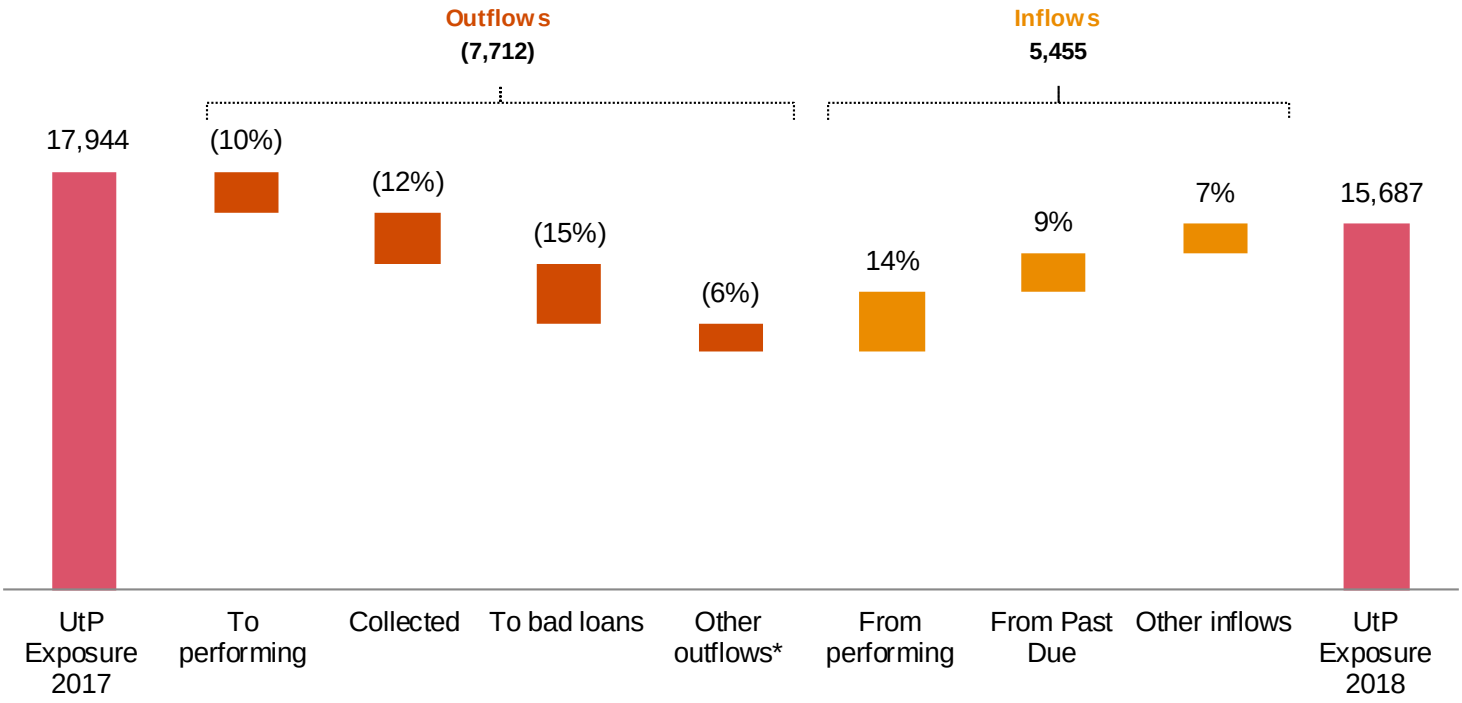
UtP inflows and outflows from 2017 to 2018

Top 10 Italian banks (€ mln)

Outflows and inflows | Unicredit

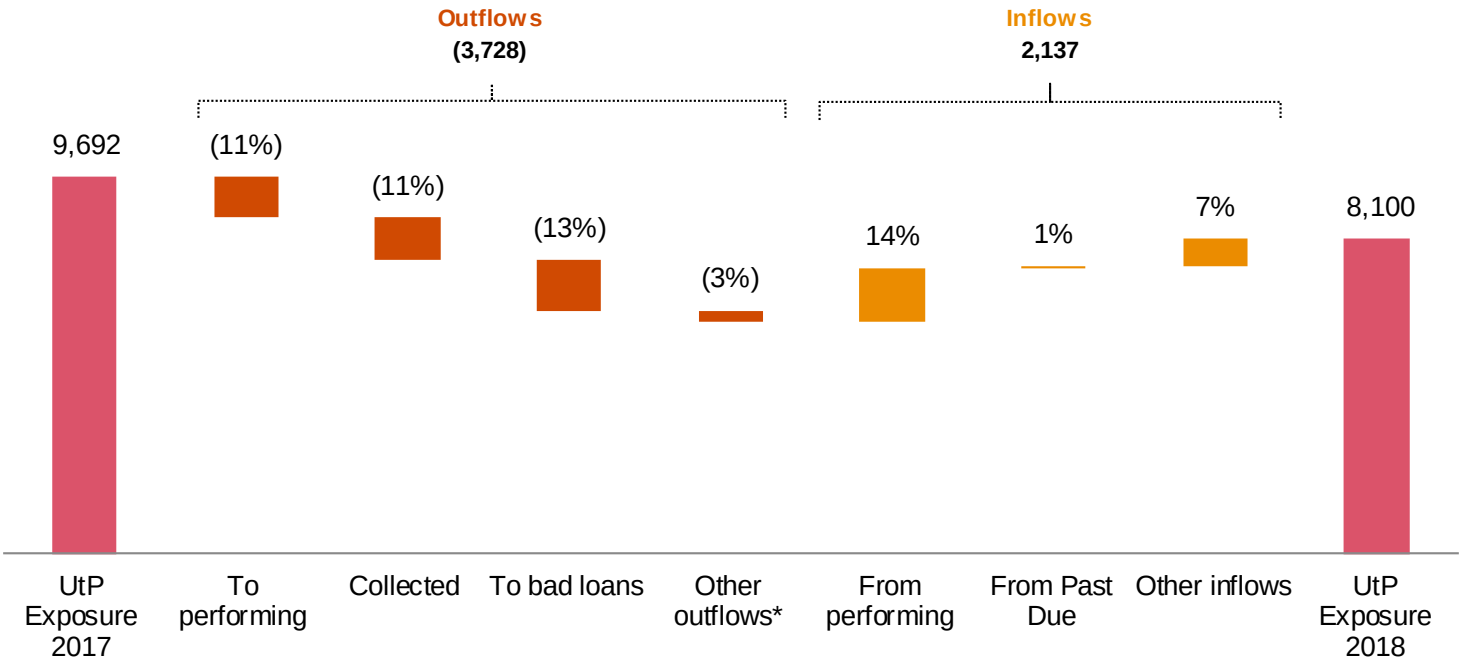


Outflows and inflows | Intesa Sanpaolo

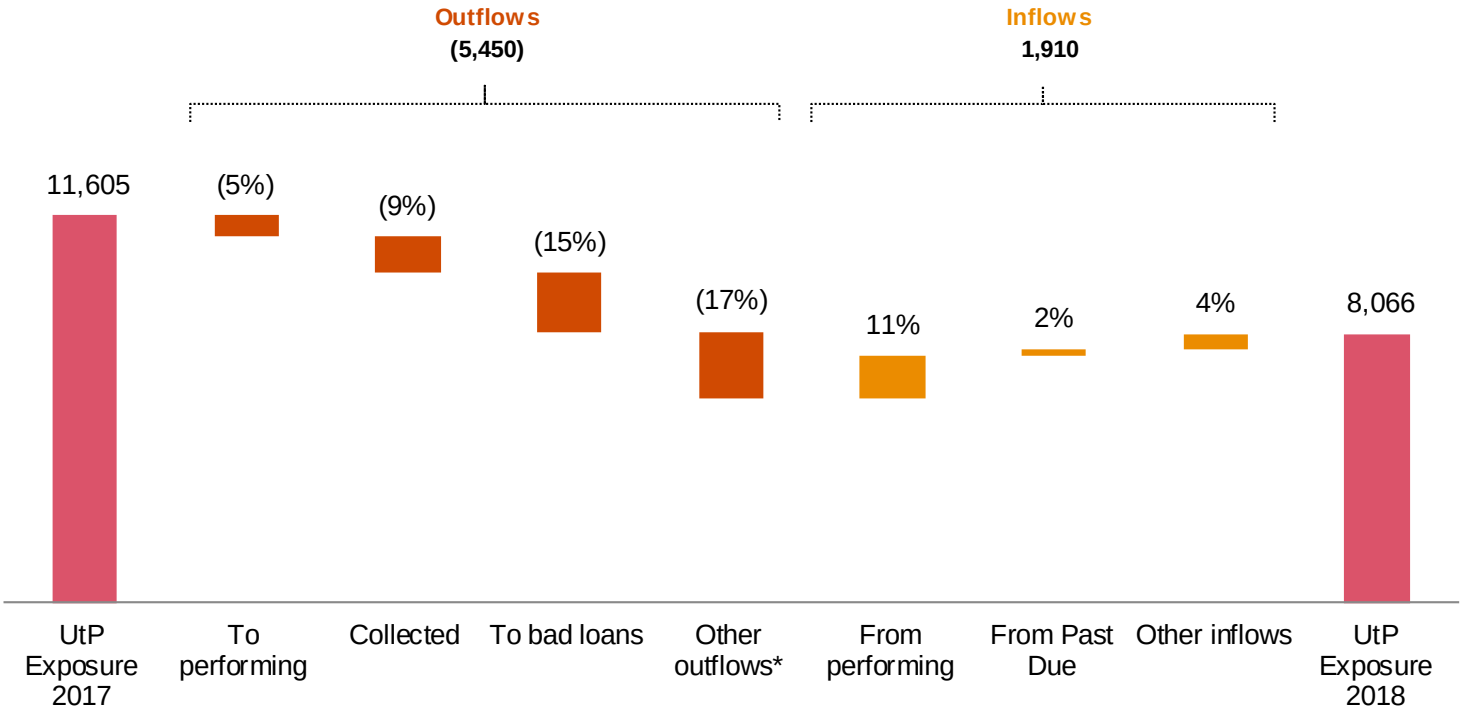


Source: PwC analysis of banks' financial statements as of Dec 2018

Outflows and inflows | Banco BPM

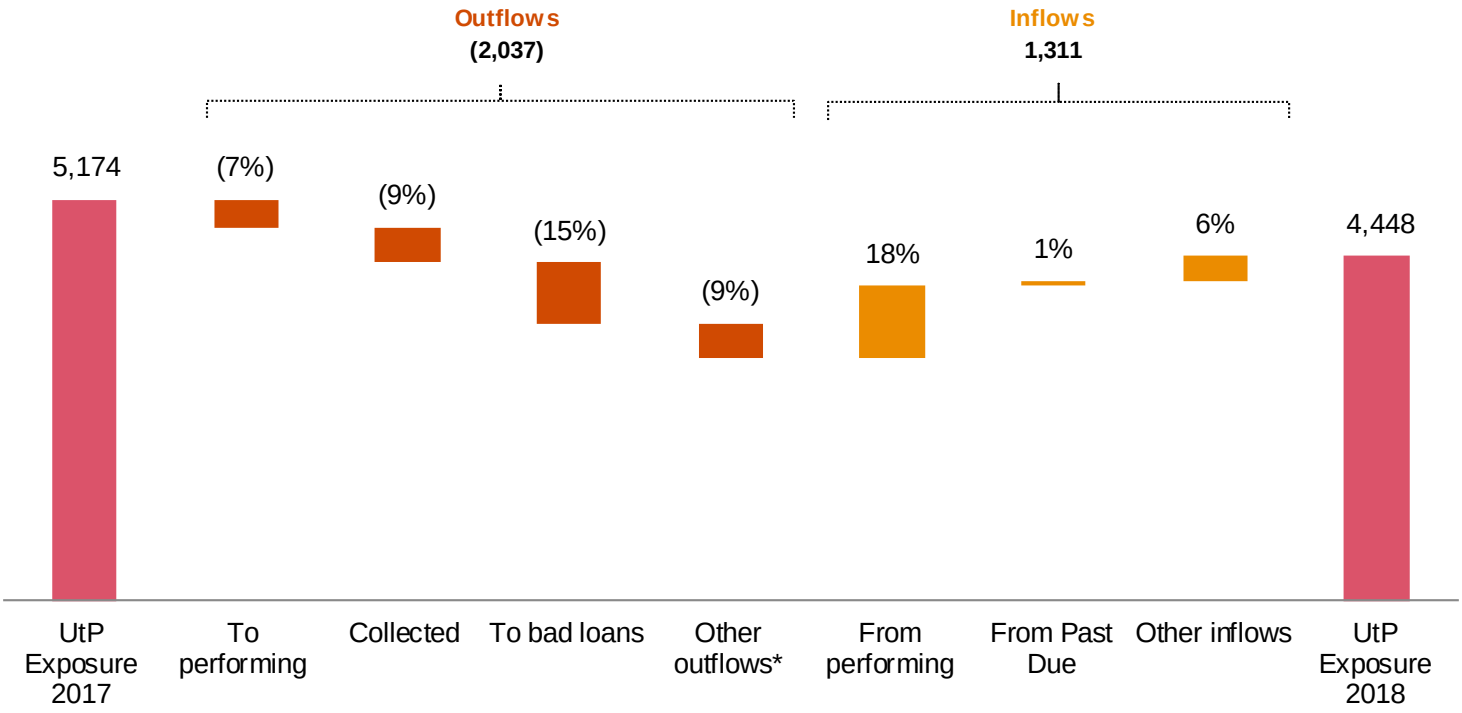


Outflows and inflows | MPS

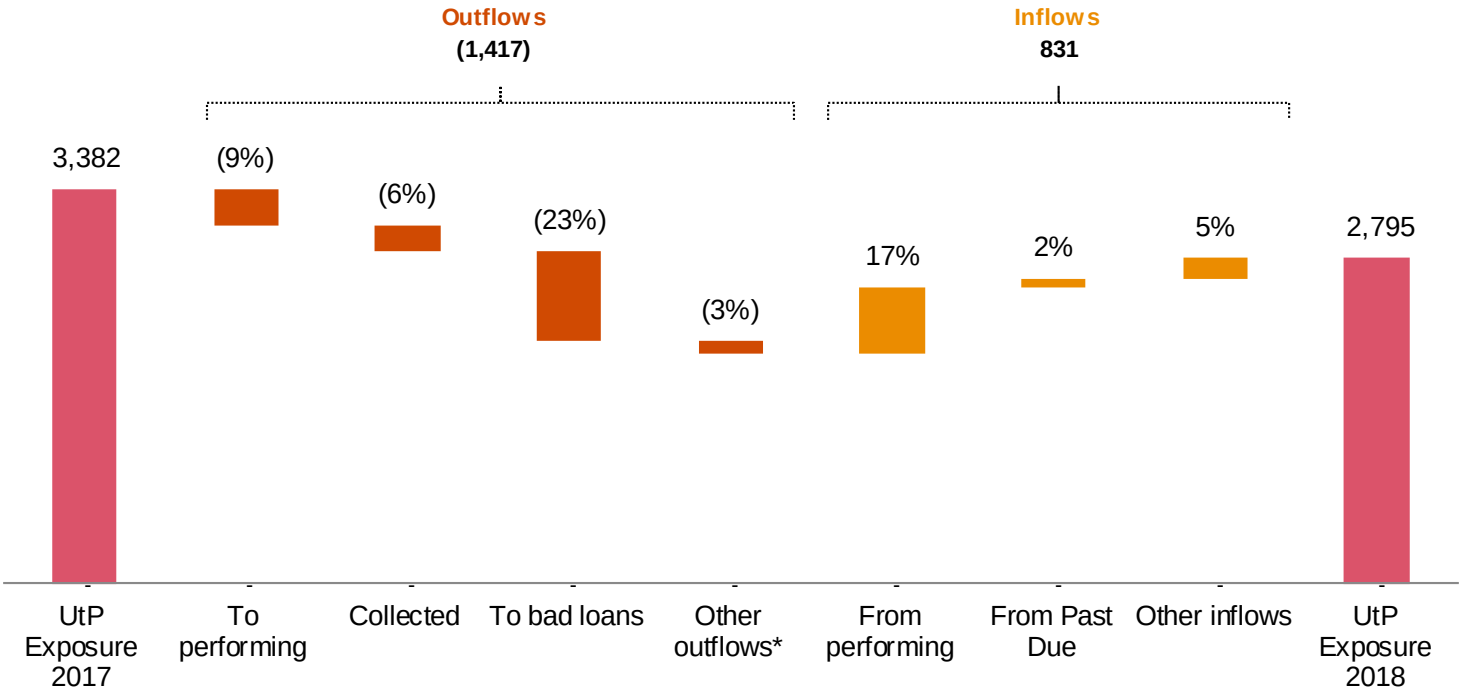


Source: PwC analysis of banks' financial statements as of Dec 2018

Outflows and inflows | UBI

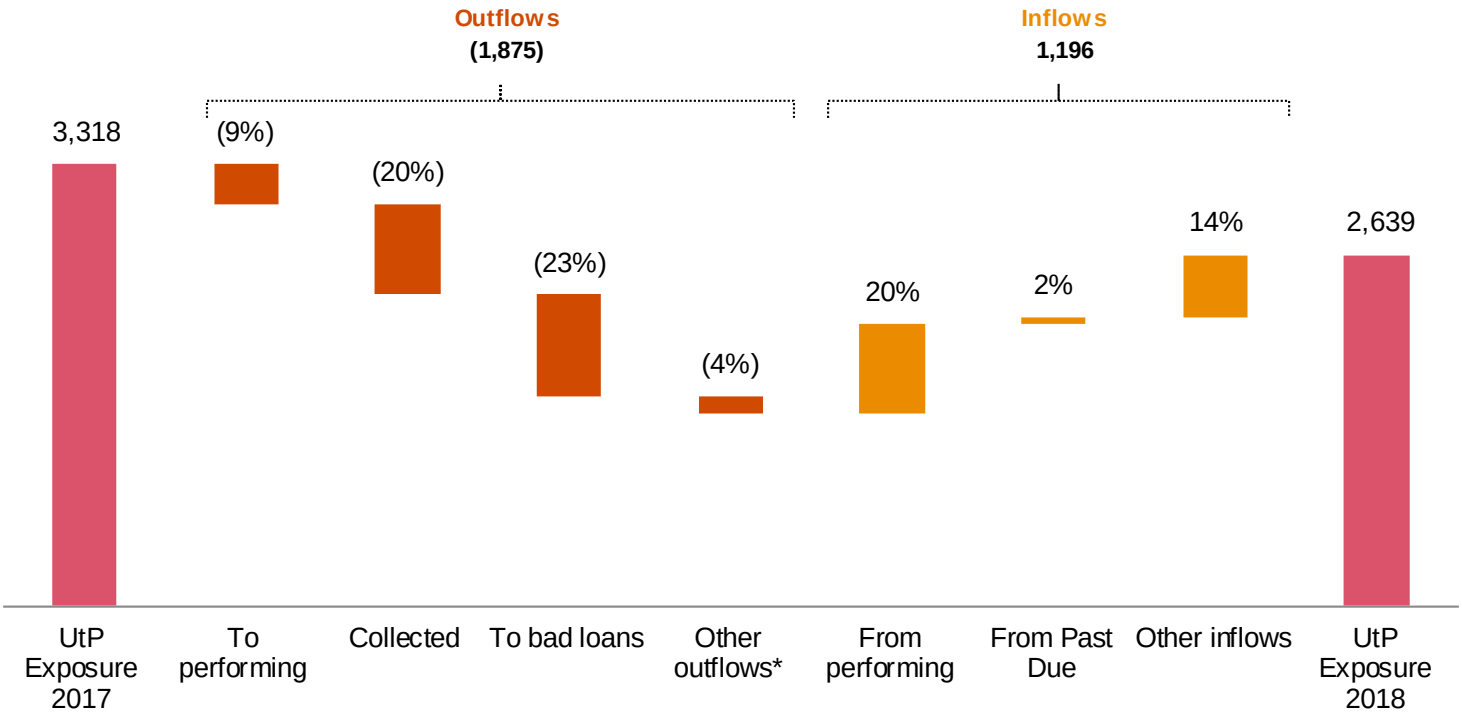


Outflows and inflows | BNL

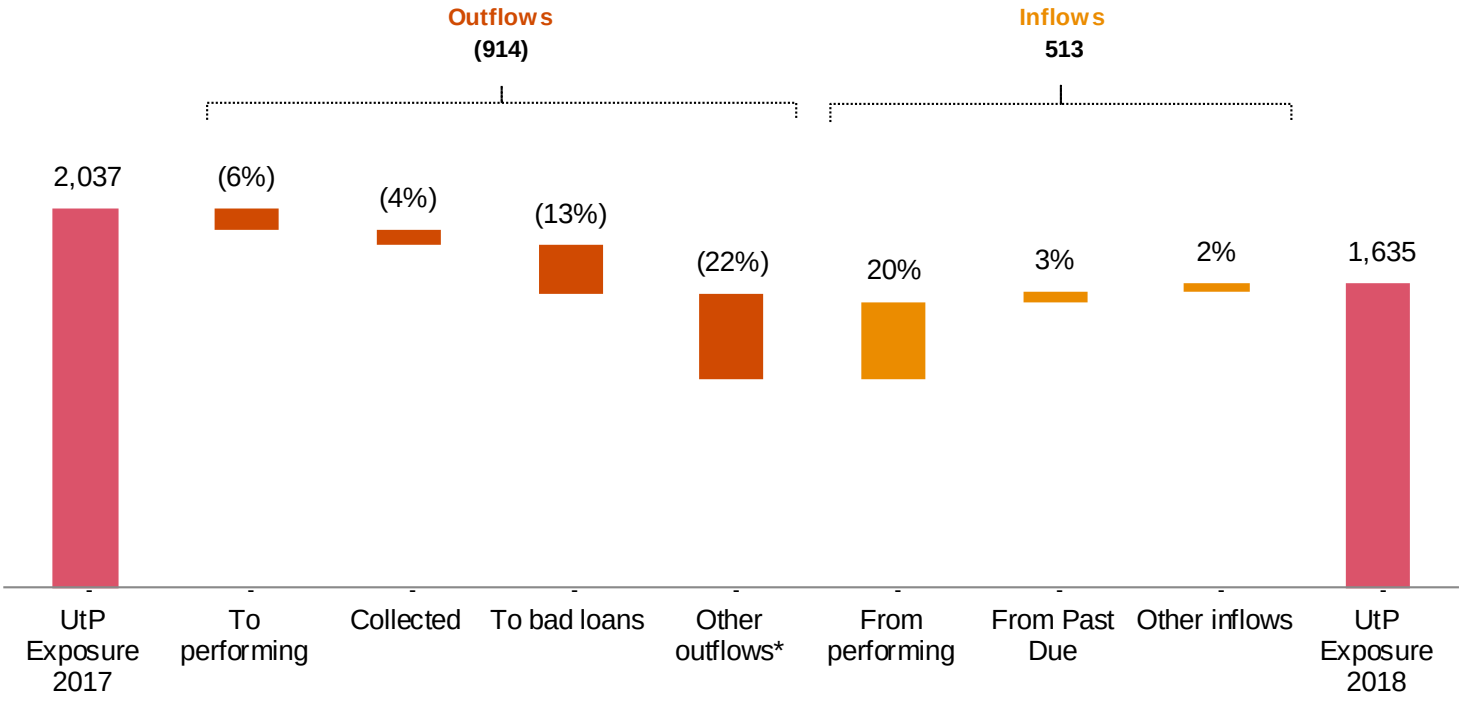


Source: PwC analysis of banks' financial statements as of Dec 2018

Outflows and inflows | BPER

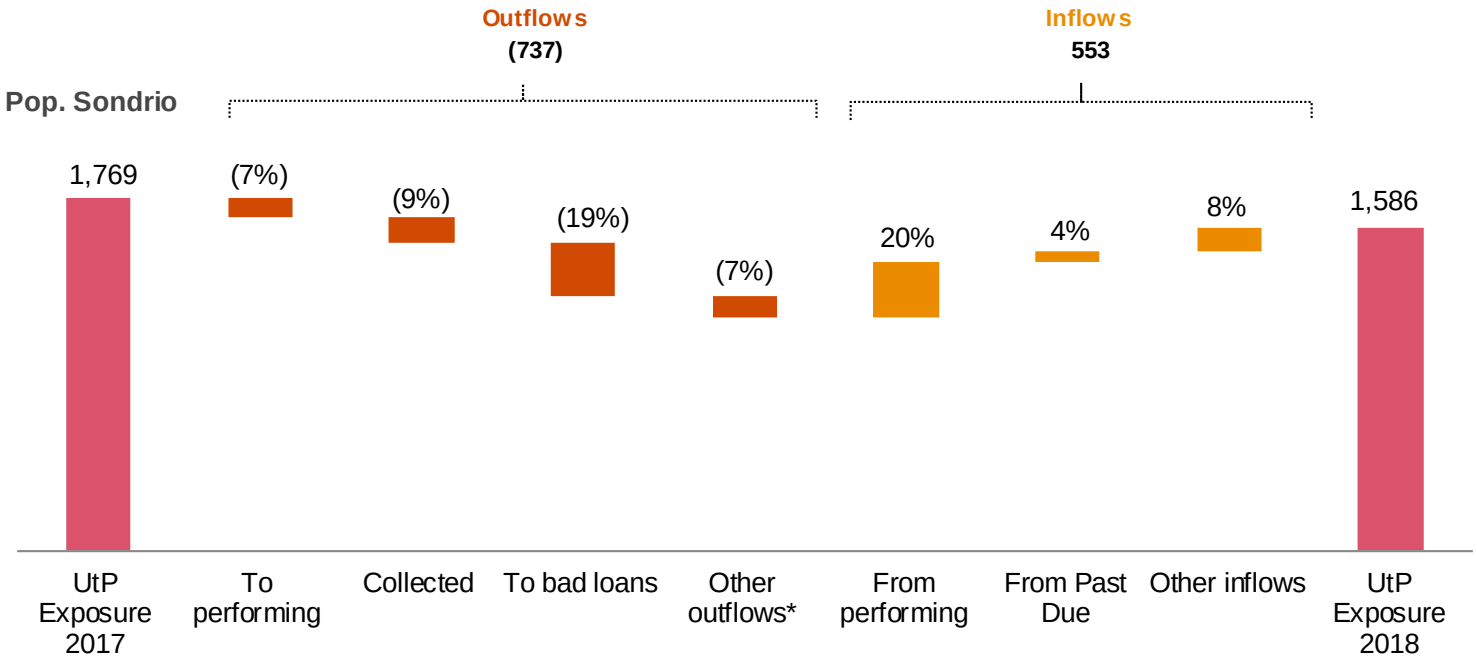


Outflows and inflows | Cariparma

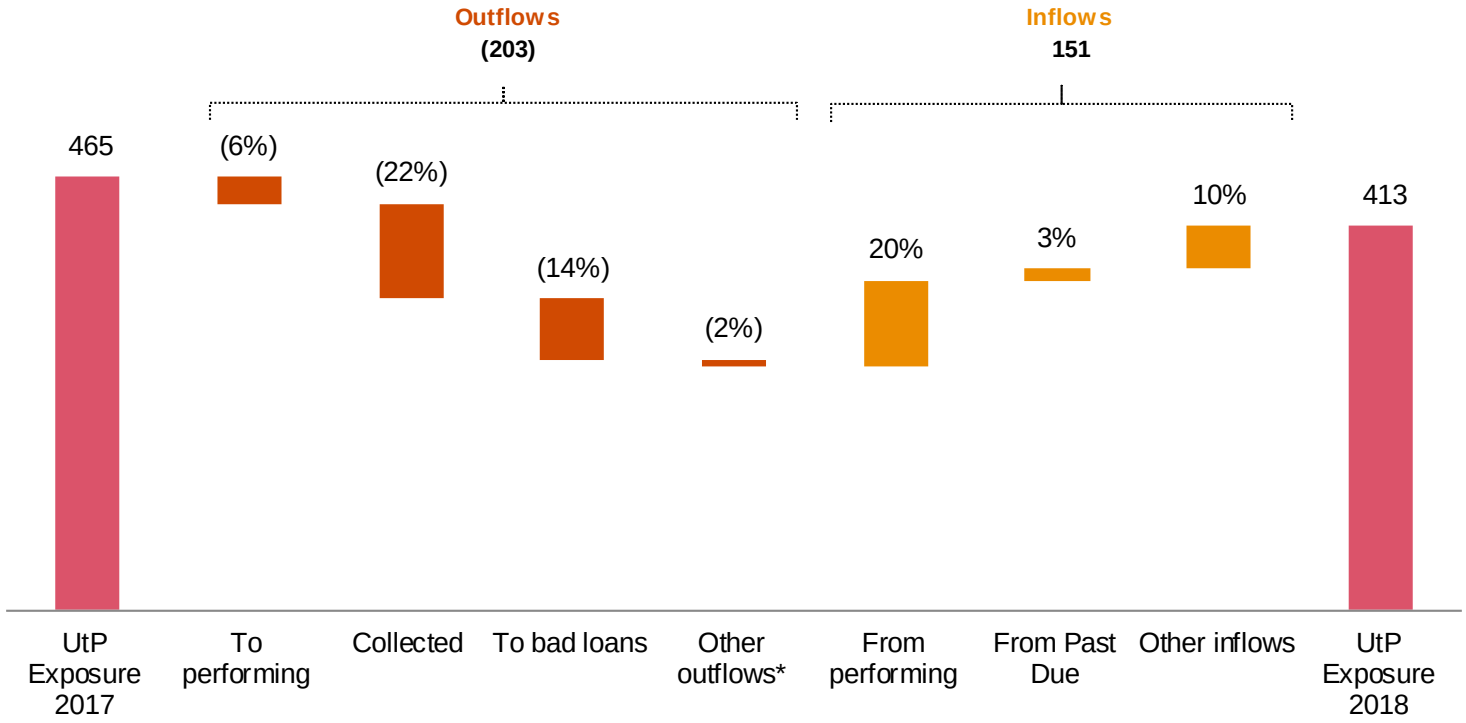


Source: PwC analysis of banks' financial statements as of Dec 2018

Outflows and inflows | Banca Popolare di Sondrio



Outflows and inflows | Credem

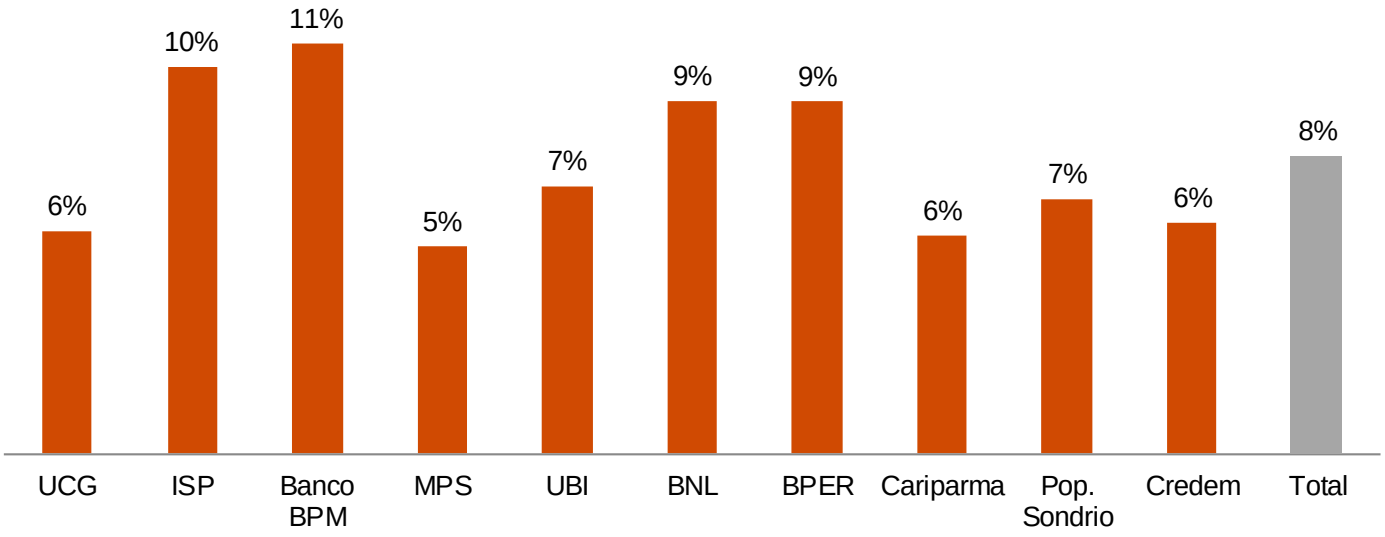


Source: PwC analysis of banks' financial statements as of Dec 2018

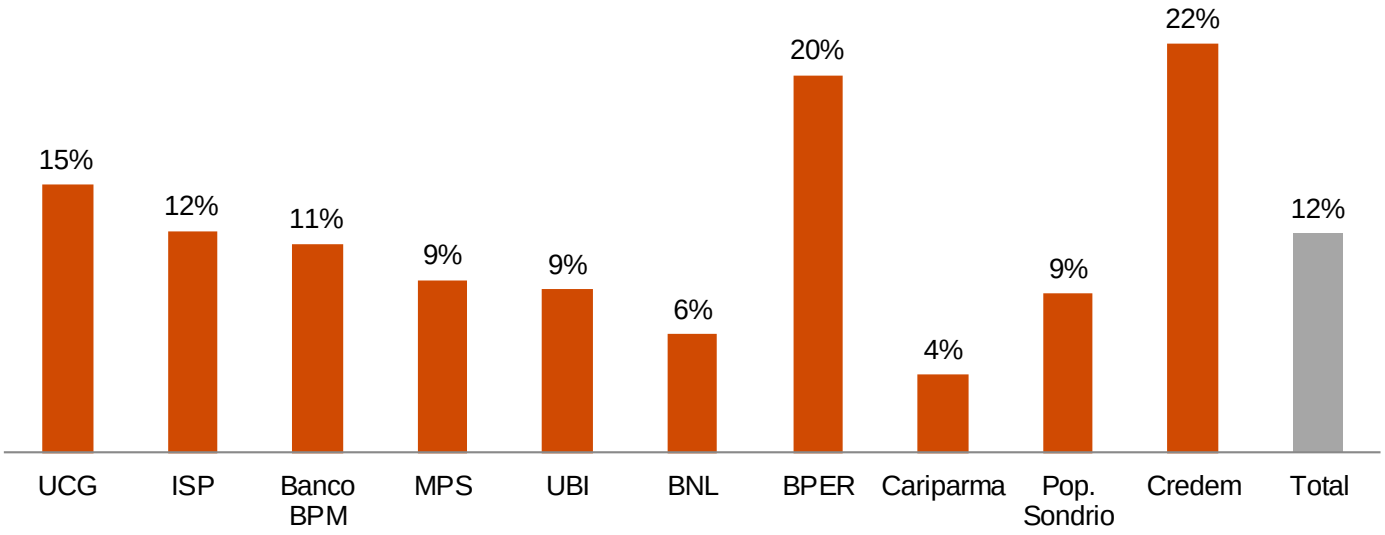
Outflows
Top 10 Italian banks

The average collection rate does not represent a significant indicator for reading the Italian system as it changes significantly from bank to bank.

From UtP to Performing in 2018

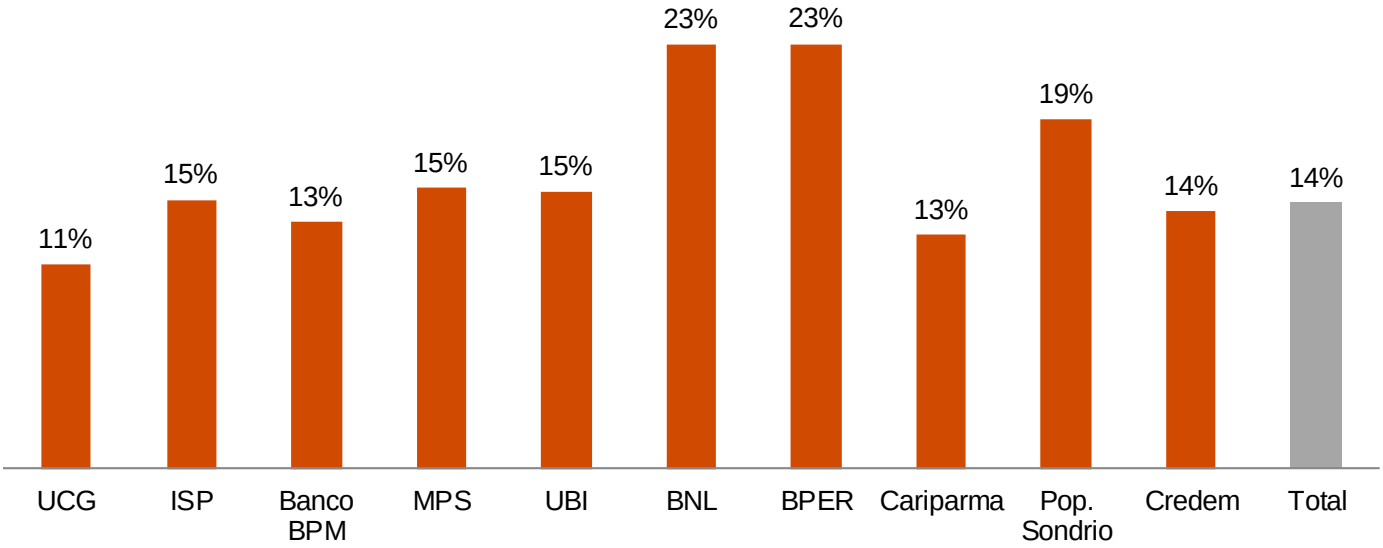


From UtP to Collected in 2018

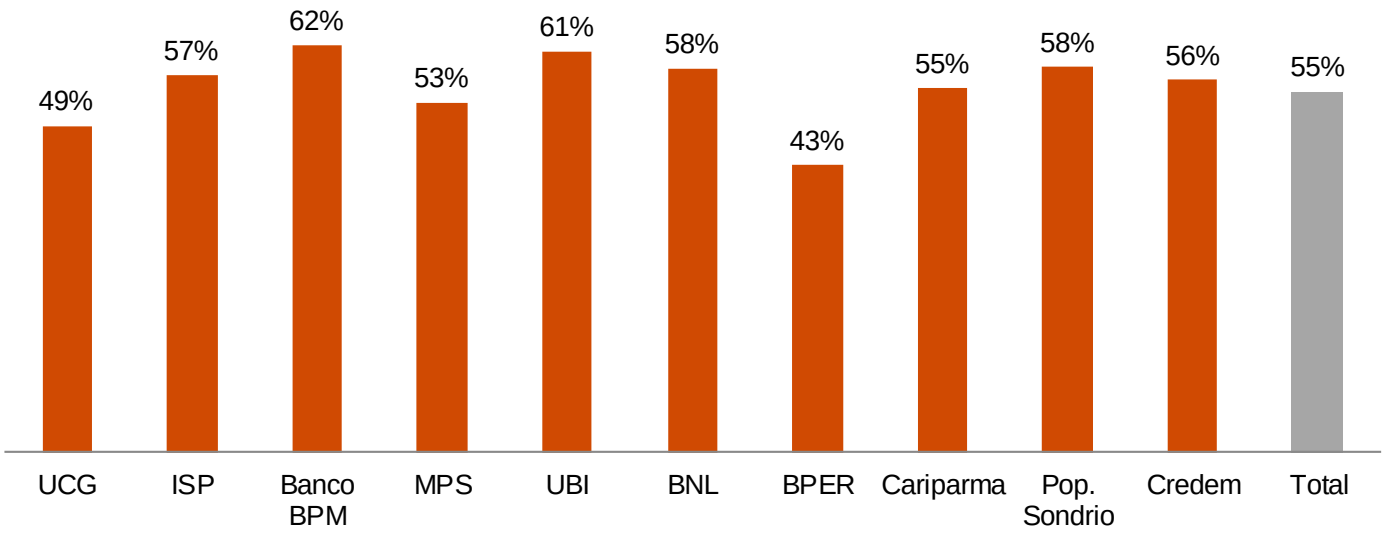


Source: PwC analysis of banks' financial statements as of Dec 2018

From UtP to Bad Loans in 2018



Remained UtP in 2018



Source: PwC analysis of banks' financial statements as of Dec 2018

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