

Commentary

From NPLs to Unlikely to Pay? Recent Trends and Credit Implications in the Italian Nonperforming Exposures Market

DBRS Morningstar

June 2023

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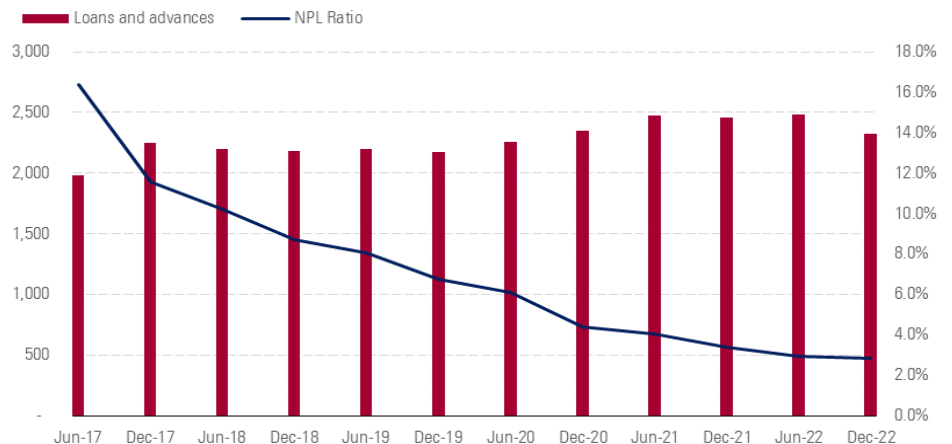
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Introduction

Following the financial crisis in 2008–09, the Italian banking sector experienced an increase in nonperforming loans (NPLs) mainly due to the adverse global economic conditions at the time. In March 2017, the European Central Bank (ECB) issued guidance to banks, acknowledging that NPLs levels had a negative impact on the economy. The ECB identified the securitisation of NPLs portfolios as one possible solution to reduce European NPL stocks. Coupled with the garanzia sulla cartolarizzazione delle sofferenze (GACS), the recent and rapid growth in the market for NPL securitisation transactions across Europe has helped Italian banks achieve the accounting and regulatory derecognition of these stocks from their balance sheets and allowed them to de-risk. In December 2017, the cumulative gross book value of NPLs on Italian banks’ balance sheets was EUR 154 billion and, as of December 2022, it had reduced to EUR 24 billion¹. This trend demonstrates that banks have adopted procedures and plans aimed at achieving the results required by the regulator.

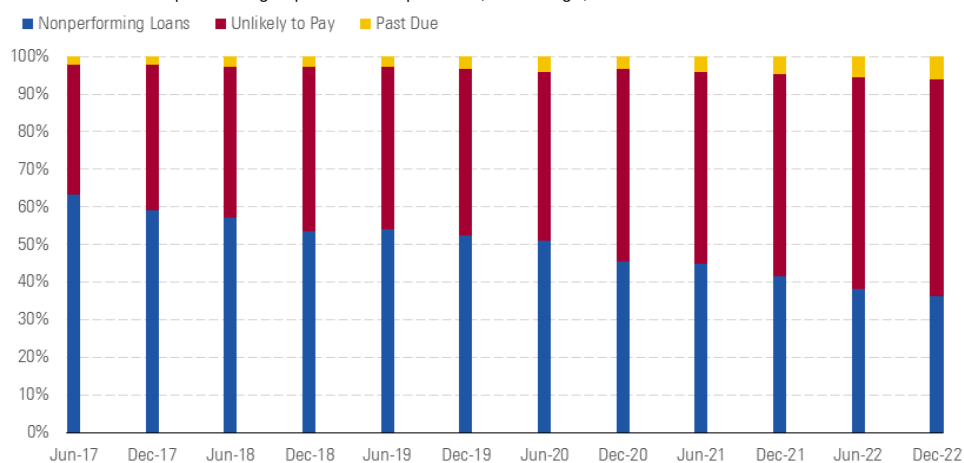
Exhibit 1 Italian Loans and Advances Volumes (EUR Billions) versus NPL Ratio (Percentage)



Source: Bank of Italy, Financial Stability Reports; DBRS Morningstar elaboration.

Although securitisation played a central role in de-risking Italian banks’ exposure to NPLs, these banks now seem to have refocused on developing processes to avoid the classification of borrowers as NPL through a preventive intervention on those defined as unlikely to pay (inadempienze probabili) (UTPs), which is the classification prior to NPLs. Such processes should result in the preservation of borrowers’ economic conditions and, therefore, the avoidance of a default. In this commentary, we analyse the latest trend toward UTPs in the Italian market, the relevant differences between UTPs and NPLs (sofferenze), and the relevant credit implications of UTP securitisations.

¹ Source: Financial Stability Report published by Bank of Italy.

Exhibit 2 Italian Nonperforming Exposures Composition (Percentage)

Source: Bank of Italy, Financial Stability Reports; DBRS Morningstar elaboration.

Unlikely to Pay: Differences from NPLs

According to the Circular no. 272 dated 30 July 2008 issued by the Bank of Italy (as amended and supplemented from time to time; the *Matrice dei Conti*), NPLs (*sofferenze*) are defined as cash and off-balance-sheet credit exposures to a party in a state of insolvency (even if not judicially ascertained) or in substantially similar situations, regardless of any loss forecasts made by the bank. The *Matrice dei Conti* defines UTPs as exposures for which, on the basis of the bank's sole assessment, debtors are unlikely to repay without the enforcement of guarantees.

The main difference between these two categories is that to be classified as a NPL, the debtor must be insolvent while, to be classified as a UTP, the bank must make an assessment regardless of whether the borrower has any payments in arrears. However, the *Matrice dei Conti* also provides for certain cases where an exposure should be classified as UTP, including cases wherein the borrower has submitted a request for a voluntary early arrangement with creditors (*concordato in bianco*) to the competent court or in the case of a composition with creditors on a going-concern basis (*concordato preventivo con continuità aziendale*).

The distinction between NPLs and UTPs also affects the securitisation process of these exposures. In most cases, NPL exposures arise from loan agreements (in different technical forms) that the bank has already terminated and, therefore, the servicer's activity will mainly focus on the recovery of unpaid amounts from the borrower once transferred to a special-purpose vehicle (SPV). On the other hand, UTP exposures arise from agreements that are still valid and binding between the parties and, sometimes, they also provide for further disbursements from the bank (e.g., in case of revolving exposures) together with any other undertakings usually provided by a loan agreement, which might include the bank's delivery of periodic communications. This results in the need for (1) more developed skills on the servicer's management side that are required to manage a loan and a contractual relationship still in place between the parties, and (2) the restructuring of the position that could not occur without the transfer of the underlying agreement and, due to regulatory constraints, it is usually carried out in favour of a bank or financial intermediaries. These rearrangements could also require the disbursement of further loans to facilitate the reclassification of the relevant debtors since these borrowers could face temporary difficulties due to particular

market conditions, such as the recent pandemic or the war in Ukraine. The further loans could be financed by the SPV through the collections, an external financing or the issuance of a class of super senior notes.

From a true-sale perspective, the fact that the underlying agreements of UTP exposures are still valid and binding between the parties could result in some issues regarding the transferability of receivables arising therefrom. In some cases, such agreements can contain clauses either limiting or restricting the transferability of the agreements or the relevant receivables to third parties. Although these limitations should not affect the validity of the transfer of the receivables in favour of an SPV, co-operation with the originator could be required to transfer the amounts repaid by the borrowers to an SPV. To mitigate any commingling risk arising from the fact that the originator can hold collections, such collections should frequently be transferred into an issuer's accounts, which are segregated in favour of the noteholders by a mandatory provision of law. On the other hand, receivables classified as NPLs usually arise from agreements that have been terminated and, therefore, there are not particular issues regarding their transferability in favour of the SPV. Since the agreements are no longer effective between the parties, any provision limiting the transferability is not applicable. Although there could be cases where the borrower continues erroneously paying the originator, this cannot be considered as a feature of the transaction.

According to the Bank of Italy², in Q4 2022, exposures classified as UTPs in the Italian banking system amounted to EUR 38 billion. As shown in Exhibit 3 below, Italian credit institutions are now also focusing on the reduction of receivables classified as UTP while, for NPLs, Italian banks had already identified a process to reduce the NPL stock—a process that, in most cases, results in the securitisation of NPL portfolios.

Exhibit 3 UTPs Stock of the Main Italian Banks

	Unlikely to Pay		
	EUR millions GBV as at 31 December 2022	EUR millions GBV as at 31 December 2021	(%)
Intesa Sanpaolo S.p.A.	6,423	7,281	-11.8
UniCredit S.p.A.	9,100	11,747	-22.5
Banco BPM S.p.A.	2,640	4,127	-36.0
Banca Monte dei Paschi di Siena S.p.A.	1,961	2,304	-14.9
Crédit Agricole Italia S.p.A.	1,980	2,328	-14.9
BPER Banca S.p.A.	1,872	1,883	-0.6
Banca Popolare di Sondrio S.p.A.	850	1,042	-18.4
CREDEM S.p.A.	373	378	-1.3
Total	25,199	31,090	-18.9

Source: Balance sheets as at 31 December 2022.

Regulatory Aspects and Calendar Provisioning

In March 2017, the ECB issued the *Guidance to banks on non-performing loans* highlighting its expectations about strategies aimed at reducing NPL exposures. In March 2018, the ECB published an addendum to the guideline outlining its expectation for bank's prudential provisioning for new nonperforming exposures and then, on 11 July 2018, a press release that further outlined the consistency of such provisioning. However, we note that these guidelines were not mandatory and

² Source: Financial Stability Report published by Bank of Italy

were addressed to banks directly supervised by the ECB (i.e., significant institutions) and, therefore, not all European banks were required to apply them. Subsequently, on 25 April 2019, the Regulation EU no. 2019/630 amending the Regulation EU no. 575/2013 (the Capital Requirement Regulation or CRR) was published in the European Union's official journal, which approved provisions of law regarding nonperforming exposures (NPEs)³ management and made them mandatory, although with some differences from the ECB's guidelines. Further to its mandatory nature, the new regulation applies to any banks in the euro area, regardless of their status as a significant institution.

Regulation EU no. 2019/630 introduced a prudential backstop in the CRR, providing for a full write-down of NPEs according to pre-established deadlines. The provision aims to avoid the accumulation of NPEs on banks' balance sheets. In particular, it provides for the deduction of certain amounts from the common equity tier 1 capital to maintain the so-called minimum loss coverage, with the purpose of covering future losses arising from NPEs. The coverage percentage depends on the period of impairment, the presence or absence of collateral (so-called secured or unsecured loans), and the type of collateral backing the loan. The calendar provisioning results in difficulties for the banks to disburse further loans to borrowers in order to facilitate their reclassification as in bonis since this will result in the application of further minimum loss coverage. On the other hand, most of the time, borrowers classified as UTP are facing a lack of liquidity due to adverse macroeconomic conditions that could worsen their ability to repay their debt exposures. As a consequence, the securitisation of these loans and their management outside the traditional banking system could support, from a borrower perspective, their reclassification as in bonis and, from a bank perspective, the capital requirements. Italian SPVs established in accordance with Italian securitisation law are also allowed to grant financing, although lending activity in Italy is reserved for banks and financial intermediaries.

In particular, SPVs are allowed to grant such loans if:

1. Borrowers are selected by a bank or a financial intermediary;
2. Such bank or financial intermediary will maintain a significant economic interest; and
3. The notes are subscribed by qualified investors.

Furthermore, pursuant to Article 7.1 of Italian securitisation law, SPVs may grant financing to (1) improve the recovery forecasts of loans classified as NPEs, originated and sold by banks and financial intermediaries, and (2) support the reclassification of the relevant borrower as in bonis.

Credit Implications for Rating UTP Securitisations vs. NPL Securitisations

From a credit perspective, our analysis of an NPLs portfolio is mainly driven by the timing necessary to recover the receivables and it is usually assessed through:

1. The data and projections provided by the servicer or sponsor (or by the arranger on their behalf) in the portfolio business plan,
2. Historical servicer recovery data (provided on a loan-by-loan basis for secured exposures and on a static basis for unsecured NPLs),

³ In accordance with the Matrice dei Conti, non-performing exposures are broken down into the categories of non-performing loans, unlikely-to-pay, past-due and/or impaired overdrafts.

3. DBRS Morningstar's exposure-level review of secured loans and/or larger loans or obligors, and
4. DBRS Morningstar's expectation of the amount of NPLs in the particular market that are likely to be worked out over the same time period.

If a servicer's role in an NPL securitisation transaction is deemed crucial, it can be even more crucial in the context of a UTP transaction. Indeed, the servicer should actively work out the UTP assets to facilitate its reclassification as in bonis (e.g., through rescheduling agreements, moratorium, company restructuring, etc.) or find the best management solution in order to maximise expected cash flows from a receivable, in both cases with the aim of generating the collections that will be applied toward repayment of the issued securities and avoiding judicial enforcement. DBRS Morningstar reviews: (1) the servicer's experience, expertise, and capabilities, including its operational capabilities and financial strength, and assesses any servicing continuity risk; (2) the loan servicer's actual performance data with respect to historical recoveries and defaults (provided on a loan-by-loan level and reflecting the loans' characteristics included in the portfolio to be securitised); (3) the data and information on the loans in the pool to be securitised; and (4) the business plan containing the strategies related to the portfolio that can be organised in clusters of receivables (e.g., positions that need to be restructured from a company perspective to increase the profitability of the business versus positions where the underlying asset has no profitability and, therefore, the main strategy is to sell them). Finally, as result of this analysis and similar to its NPL analysis, DBRS Morningstar determines expected and stressed collections over time in different rating scenarios.

DBRS Morningstar reviews applicable legal documents to determine their impact on the transaction structure and to confirm that they are in line with the expectations described in DBRS Morningstar's [Legal Criteria for European Structured Finance Transactions](#).

Investment Funds Structure: An Alternative to Securitisation

The use of securitisation is not the only instrument that market participants use to proactively manage UTP exposures. In the past few years, Italian banks have also turned to alternative investment fund (AIFs) structures to achieve the same results. Indeed, in accordance with the definition of collective investment undertakings (organismo di investimento collettivo del risparmio) and Article 46-bis of Legislative Decree No. 58 dated 24 February 1998 (the Italian Financial Act), Italian AIFs are entitled to grant loans out of their own assets in favour of entities other than consumers.

According to the Bank of Italy/Consob/IVASS Document no. 8, [Treatment in the financial statements of sales without recourse of unlikely-to-pay loans in exchange for units of investment funds](#), published in April 2020, an investment fund structure usually provides that a portfolio composed mostly of UTP exposures is transferred without recourse (pro soluto) to an AIF; the AIF, as consideration for the relevant portfolio, issues units that are then subscribed by the same originators.

Such structures also allow for the possibility of disbursing additional loans to the borrowers to facilitate their reclassification as in bonis, which can be financed either through the issuance of special categories of units or the recognition of a debt in favour of external lenders. This feature

highlights the fact that one of the main issues with managing UTP exposures is the regulatory constraints applicable to banks and financial intermediaries.

The main AIFs currently in place⁴ with the above-mentioned structure and purpose are:

1. Back2bonis managed by Prelios SGR S.p.A. with AMCO S.p.A. as master servicer;
2. UTP Italia Fund managed by Sagitta SGR S.p.A. with Zenith Service S.p.A. as master servicer and Intrum Italy S.p.A. as special servicer;
3. Efesto managed by Finint SGR S.p.A. with Italfondiaro S.p.A. as master servicer;
4. Responsible & Sustainable Corporate Turnaround Fund; and
5. Credit & Corporate Turnaround Fund managed by illimity SGR S.p.A.

From a legal perspective, we note that, in accordance with Article 7, paragraph 1, letter (b), Italian securitisation law also applies to the transfer of receivables in favour of AIFs that have underlying receivables, established in accordance with the Italian Financial Act; therefore, the features of these transactions should be in line with traditional securitisations. Furthermore, in case of transactions carried out through an AIF structure, the management company can also act as a servicer of the transaction.

Conclusion

Although the Italian UTP market cannot be considered as developed as the NPL market, DBRS Morningstar understands that Italian banks will be facing in the coming years a new challenge: the development of clear and efficient procedures for managing their UTP stocks. Considering the regulatory constraints, in our view, securitisation and AIF structures could play an important role and, therefore, banks could continue developing specialised platforms with such purpose. Furthermore, DBRS Morningstar is of the opinion that proactive management of UTP stocks could lead to a decrease in Italian banks' NPL ratios since a preventive intervention could result in the preservation of a borrower's economic conditions and the avoidance of default.

Compared with NPLs, DBRS Morningstar's view is that UTP receivables can be considered as a more challenging asset class due to their characteristics that require proactive management, more developed skills, financial capacity, as well as advanced IT platforms to support servicers' and originators' activities. Indeed, depending on the characteristics of each borrower, servicers and originators, in order to maximise their collections, are required to develop specific credit recovery strategies, expertise, and to continuously improve specific policies and procedures. Due to the current macroeconomic environment, we believe that these strategies could change as a consequence of high interest rates and inflation that might result in the borrowers' difficulty to (1) obtain new finance and (2) repay their loans even if these have already been restructured or managed properly. Indeed, DBRS Morningstar believes that such macroeconomic conditions are not as relevant in NPLs as they are in UTPs, given that for NPLs the management activity is mostly focused on the judicial recovery and not on the avoidance of default.

⁴ Source: balance sheets of Intesa Sanpaolo S.p.A., UniCredit S.p.A. and Banco BPM S.p.A.

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