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Topical issues

Reforms to help kick-start Italy's NPL market

Forward

Non-performing loans sit heavily on the balance sheets of Italian banks weighing down profits and threatening the wider economy. They now make up around 18% of all lending in Italy – around one third of the Euro area's €1 trillion NPLs and equivalent to about 20% of Italian GDP. UniCredit's €81bn gross NPL exposure alone tops that of the UK as a whole. How to deal with them has been something of a sensitive issue in recent months for Matteo Renzi's government, juggling to solve the Italian bank crisis without triggering EU State Aid rules which would require a bail-in of Italian bank bondholders.

The summer slump in Italian bank stocks may have been sparked by Brexit fears, but it was compounded by the scale of Italy's NPL woes in the wake of the EBA's stress tests published at the end of July. Asked by the ECB to cut its gross NPL exposure by 2018, Banca Monte dei Paschi di Siena put its entire bad loan portfolio for sale. With a net book value of €27bn (almost €47bn gross), a lower than expected portfolio price of around €9bn spooked equity investors. Already a drag on profits, if a similar discount were applied to the huge stock-pile of legacy NPLs of the other Italian banks, the EBA health check raised the spectre of significant additional capital increases.

But, the Italian Government has sought to develop a strategy to address the critical levels of NPLs. Recent years have seen Italy introduce sweeping insolvency, enforcement and debt recovery reforms, gradually transforming it from a substantially debtor-friendly regime to one which now recognises the benefits of providing a more creditor-focussed framework. It has also taken measures to get rid of debilitating structural inefficiencies in the judicial system and capitalise on 21st century digital technology to cut bureaucracy and administration costs. Together with other targeted legal, regulatory and tax changes, the Italian government hopes to improve the environment for loan collection, to encourage improved outsourcing and servicing of NPLs as a means to accelerate the banks' deleveraging of their balance sheets and to grow Italy's embryonic market for NPL sales and securitisation.

State of the NPL problem in Italy

As **Chart 1** illustrates, NPLs of European banks amounted to over €1 trillion of which the five Italian banks in the 2016 EBA stress tests make up some €225bn.

As at December 2015, across all Italian banks the gross amount of NPLs stood at around €360bn but this figure appears to have fallen in recent months. In its Q2 2016 Statistical Bulletin, the Bank of Italy put the worst type of NPLs – the so-called '*sofferenze*' or bad debts owed by debtors declared insolvent or in a comparable situation – at around €197bn (gross), down from €200bn in Q1. The remaining amount of impaired loans are either likely to default or are already past due. At around €160bn, these are loans which could, in other words, go on to cause further problems for Italian banks – not least further loss provisioning, potentially impacting on capital ratios.

Italian banks' NPL problem reflects troubles across corporate Italy. The vast majority of impaired bank loans are to non-financial corporates – they make up about three-quarters of all *sofferenze*.

An IMF working paper published in July 2016 notes that as at end 2014:

> 75% of the total number of NPLs were for loans under €75,000; and

> the greatest exposure by value was to loans over €250,000 – while they made up only around 25% of the total number of NPLs, they represented over 75% by value.

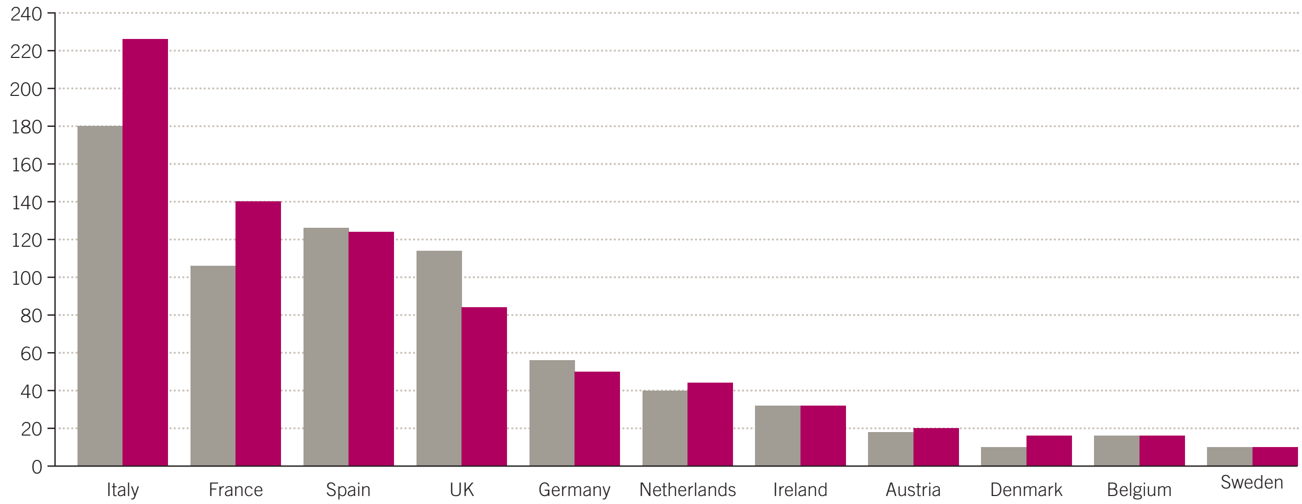
Given the high number of small loans and proportion of corporate NPLs, the paper suggests that it is likely that loans to Italian SMEs form a large part of the corporate NPL figures.

The IMF paper also highlights that there is a pronounced regional dimension to the NPL problem in Italy. The further south you travel, the greater the NPL ratio becomes (the ratio of non-performing loans to total gross loans).

The Governor of the Bank of Italy has tried to play down fears about Italy's NPLs, expressing the view that market concerns are overstated and rejecting the idea that supervisors are pushing for immediate NPL disposals. He has also been keen to point out that the value of the collateral securing those bad debts exceeds the book value of the loans: net of write-downs, the end-2015 amount of *sofferenze* drops to €87bn of which €50bn is backed by collateral worth an estimated €85bn (with the remaining €37bn being backed by personal guarantees or unsecured).

Chart 1

NPL volumes, €bn, year end 2013 and year end 2015, banks included in the 2016 stress tests



	Italy	France	Spain	UK	Germany	Netherlands	Ireland	Austria	Denmark	Belgium	Sweden
YE 13-15 change	**+26%**	**+32%**	**-2%**	**-27%**	**-16%**	**+1%**	**+1%**	**+8%**	**+60%**	**-4%**	**-7%**
Number of banks in 2016 sample	5	6	6	4	9	4	2	2	3	2	4

Note: The 2016 stress tests cover 70% of banking assets and reveal €761bn of NPLs, extrapolated to €1 trillion
Source: 2014 AQR data, EBA 2016 stress tests, Linklaters' Tactical Opportunities Analysis

However, Italy's corporate NPLs are largely made up of firms in the construction, manufacturing, real estate and retail sectors. Common forms of collateral granted by such corporates will include plant, machinery or equipment used in the business. This is unlikely to retain the value ascribed to it in a bank's balance sheet if the business should collapse (making the benefits of an effective turnaround regime particularly important). Real estate is also going to be a common form of collateral, but the Italian property market has suffered a severe decline since the financial crisis.

Of course, the major difficulty facing banks is that even with security, when it comes to enforcement, they face significant delays in recovery times and, as a consequence, reduced recovery rates (as discussed below).

NPLs generated by the financial crisis cast a long shadow

The EBA reported in July that, as at March 2016, the average NPL ratio in the EU stood at 5.7%. In Italy, that figure is more than three times as high (see **Chart 2**).

In the U.S., by comparison, the World Bank reports a NPL ratio of less than 2% at the end of 2015. While NPL ratios surged in the U.S. and the EU to similar levels between 2007 and 2009, it is only in the EU – and Italy in particular – where NPLs have accumulated to form present stockpiles.

Cyclical recessionary and stagnation pressures in Italy explain why banks saw a sharp increase in the growth of NPLs from 2007 onwards. In a poor growth environment, corporate distress levels soared reaching historic heights in 2014. But Italy's economic troubles do not fully explain the mass of NPLs which continue to loom on the horizon in 2016.

Italy's NPL misfortune is really a combination of two factors: a steady flow of new NPLs resulting from macro-economic conditions (although the rate of growth of new NPLs appears to be decreasing according to recent data) and an inability to deal with the NPL overhang resulting from the financial crisis. At its root, the legacy issue is down to embedded structural problems in the legal and regulatory system, in particular:

> **court processing time:** a 2015 IMF working paper reported that Italy had the slowest court system in the adjudication of civil and commercial disputes of all major economies in the EU. Court backlogs represent a clear impediment to swift credit recovery

> **long insolvency and enforcement procedures:** the average duration of insolvency procedures in Italy is around six to seven years. Even though almost 50% of NPLs are backed by some form of collateral, enforcement procedures typically take over four years, with significant variations between the north and south of Italy and further depending on the administration in local courts

> **immature markets for NPL disposals and securitisation:** 2015 saw €9bn worth of NPLs sold in Italy, but this represents just 2.5% of all Italian NPLs. Lengthy recovery times, low recovery values of collateral (in particular, real estate) and the costs of enforcement have all contributed to a significant pricing gap between investors and banks for NPLs, holding back the development of an active market

> **inability to easily restructure distressed debtors:** without an effective cram-down mechanism until recently, a set of varied and complex procedures and a conventional imbalance in power between creditors and debtors, the restructuring of struggling corporate debtors has proved hard to achieve

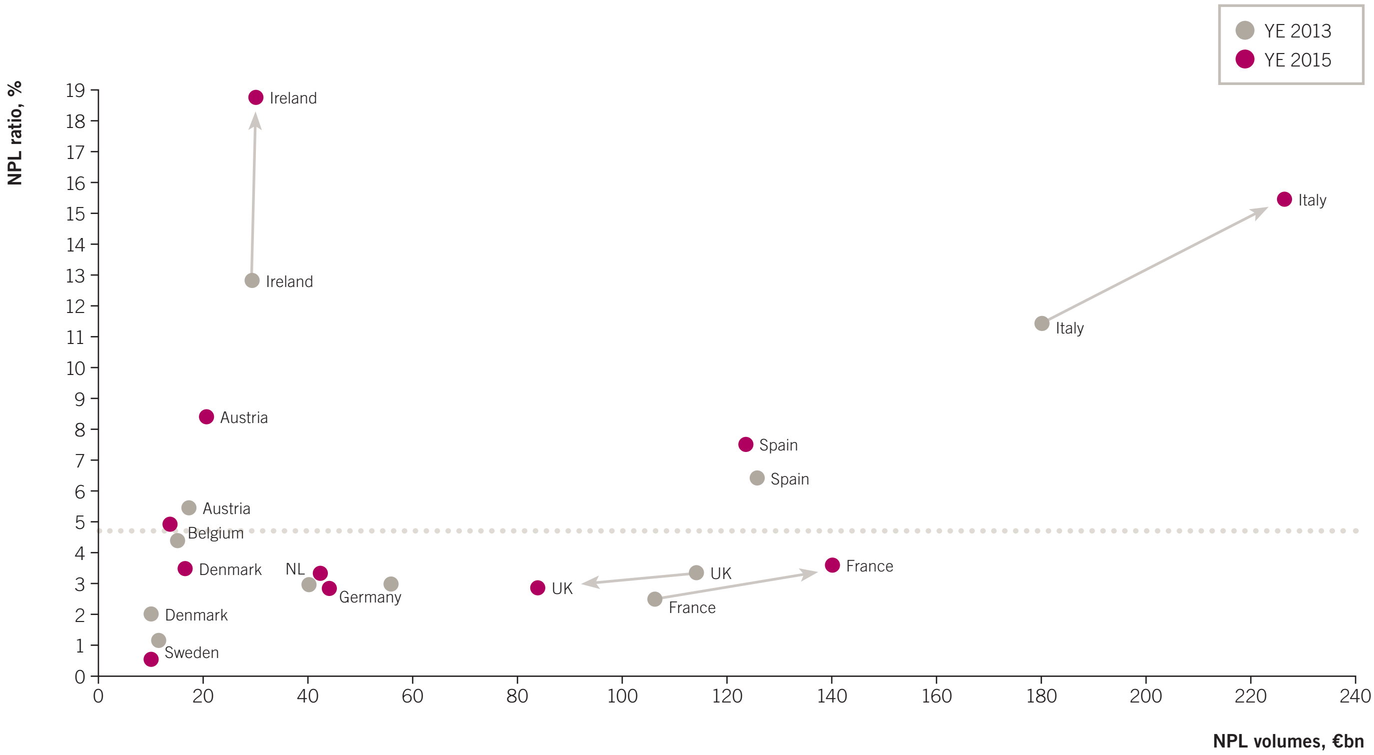
> **fiscal deterrents against provisioning:** historically, loan loss provisions could only be deducted over a five-year period (until 2012, it was 18 years) creating a disincentive for banks to write-off their bad debts or sell them at their actual market value

Taking on the NPL problem: legal and regulatory reform

A bank faced with a bad debt has, broadly, three options: sue for collection and/or enforce asset security, dispose of the debt on the secondary market (e.g. an outright sale or as part of a portfolio securitisation) or attempt to restructure the debtor. Historically, all such solutions have been challenging in Italy.

Chart 2

European NPL ratios and volumes



Source: 2014 AQR data, EBA 2016 stress tests, Linklaters' Tactical Opportunities Analysis

Through a broad range of legal reforms introduced in August 2015 and May 2016, progress is underway to speed up judicial and non-judicial debt recovery, collateral enforcement and insolvency procedures and to promote out-of-court turnarounds and restructurings. The key highlights of the reforms are[1]:

Faster recovery times

> simplifying the court enforcement process: judicial enforcement proceedings have previously involved multiple auctions – often three or four – before collateral could be sold. Under the reforms, an auction process is now intended to be used only as a last resort and instead the sale will be carried out by way of sealed bids provided certain conditions are met, including as to price. While the courts will continue to fix a minimum sale price for the collateral, this must now be on the basis of its market value. The reforms allow the courts to authorise a sale for less, but only if the offer on the table is no lower than 75% of the minimum price and the judge believes that there is no serious likelihood of getting more in a new round of bids. Along with this, preference is also now given to credit bids (subject to minimum requirements). Time limits have also been imposed on certain procedural aspects of the forced sale process and restrictions are put on debtors seeking to challenge enforcement after the fact

> shortening liquidation proceedings: where a debtor is subject to *fallimento*, there is now a two year deadline by which the asset liquidation must be complete, unless the insolvency administrator seeks court approval to extend. The insolvency administrator is also required to prepare the liquidation plan within 180 days of the insolvency declaration

> enabling pre-baked out-of-court enforcement: lenders and borrowers can make a repossession arrangement in advance under which, on a payment default, the lender will be able to exercise a right to have title to real estate assets transferred to it automatically. For loans with monthly or shorter repayment schedules, there must be a default of at least three instalments lasting for a nine month period. For loans with longer repayment schedules or having a bullet repayment date, the lender's repossession right will trigger if the debtor fails to pay on an instalment date (e.g. a missed quarterly repayment) or the final maturity date, as relevant, and that payment default continues for a nine month period. This fast-track enforcement route only applies to new loans from May 2016, unless the finance agreement is amended, and does not apply to the debtor's home. The lender may also exercise its repossession right during judicial enforcement or insolvency proceedings

Improving transparency

> using websites to improve access to enforcement and insolvency information: consistent with the aim of the revised European Regulation on Insolvency Proceedings to create a central 'European e-Justice Portal' linking national insolvency registers, the Ministry of Justice will host a single national on-line database containing relevant information on all court-ordered real estate enforcement sales and insolvency and pre-insolvency filings

> enabling creditor engagement through technology: creditors will now be able to attend creditor meetings in insolvency and pre-insolvency *concordato preventivo* proceedings through telephone or video conference links. This should make it easier in particular for foreign investors to protect their interests

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1 Further detail on the August 2015 reforms is available in *Recent reforms of Italian insolvency law: introducing the Italian Scheme of Arrangement and making Italian concordato preventivo a more creditor friendly procedure* and in *The new Italian floating charge, repossession agreement and further measures to facilitate credit recovery* for the May 2016 changes. Please contact us for copies.

Promoting creditor rights

- facilitating majority financial creditor restructurings: Italian insolvency law now provides for the ability to cram down hold-out financial creditors if supported by 75% in value of the other financial creditors. The new Italian scheme of arrangement procedure is restricted to debtors with at least 50% of their overall indebtedness owed to banks and financial intermediaries
- improving creditor rights in composition arrangements: provided they represent at least 10% of the debtor's financial debt, creditors are better able to protect their interests in the *concordato preventivo* procedure by putting forward an alternative composition plan to the one proposed by the debtor, but only if the debtor's proposal does not provide for payment of at least 40% of the total amount of unsecured debt (or 30% where the debtor's plan seeks to preserve the business as a going concern)
- greater protection for interim financing: priority interim financing arranged to support a debt restructuring arrangement or composition plan may now be provided at an earlier stage in proceedings. This should improve the chances of a successful turnaround for the debtor. It will rank senior to the unsecured debt, but junior to prior existing secured debt
- making additional collateral available to secure loans: following an earlier relaxation of the rules on licenses to lend, banks and various alternative credit providers can now secure their loan through a new type of Italian floating charge. The Italian floating charge is available to secure moveable assets required in the business, both tangible and intangible (including receivables), whether present or future and whether specific or forming part of an identifiable class (e.g. machinery). It can secure both present and future claims (provided a maximum amount is stated). It offers flexibility to the debtor who retains possession and protects the creditor whose security also attaches to any replacement assets or sales proceeds on disposal by the debtor. The security is not available over assets requiring public registration (such as cars, aircraft or ships) and can only be granted in respect of finance provided for use in the business (i.e. directors can not secure their personal loans using this security interest)

Incentivising balance-sheet NPL write-offs through the tax system

Italian banks are now allowed to fully deduct loan loss provisions and losses on NPL disposals in the same year they are booked, rather than having to spread them out over a five year period.

GACS: state guarantee scheme to make NPL securitisations more attractive

Earlier this year, the Italian Government took a significant step to foster the development of the NPL market by enabling access to a state guarantee scheme for senior tranches of NPL portfolio securitisations.

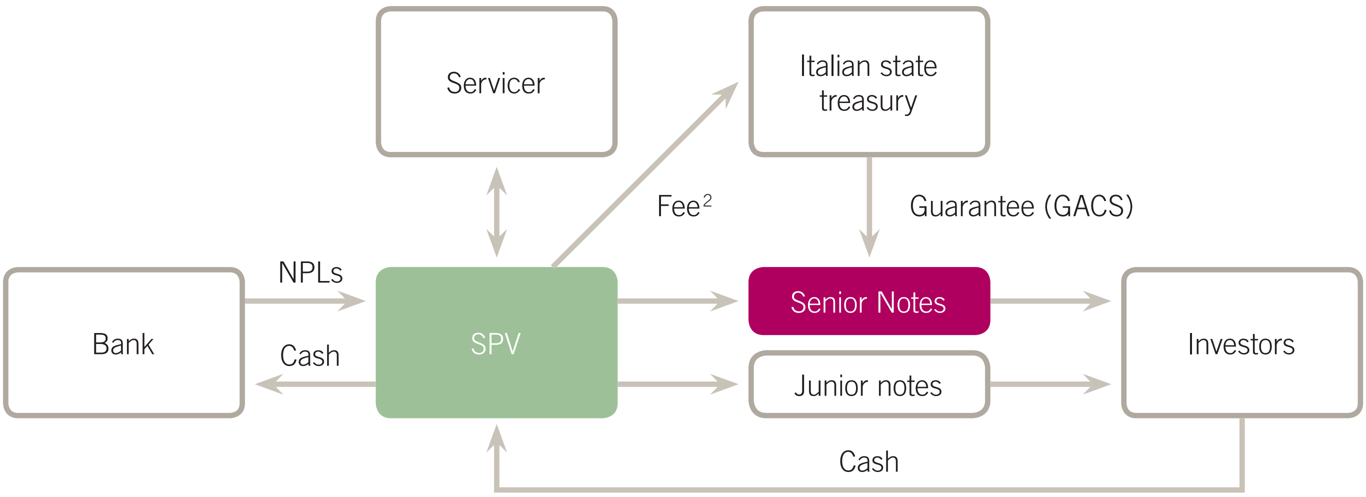
Ireland and Spain sought to clean-up their NPL mess by creating state-backed 'bad banks' (or asset management companies) to buy problem NPLs at knock-down prices. But that option has effectively been ruled out in Italy (and elsewhere in the EU) because it may constitute State Aid triggering bail-in rules introduced by the Bank Recovery and Resolution Directive from 1 January 2016.

Imposing heavy losses through a bail-in on subordinated debt holders many of whom are, in Italy, household investors would be politically unpalatable.

Instead, the European Commission agreed in January 2016 to allow Italy to provide a state guarantee, offered at market conditions, for senior tranches of NPL portfolio securitisations with investment grade rating – the *garanzia sulla cartolarizzazione delle sofferenze* or GACS. The diagram below shows how the scheme is intended to work.

It is a pre-condition to the availability of the GACS scheme that there is a servicer independent from the originating bank. NPL Investors will want to ensure that there are experienced servicing platforms in place. The key will be finding specialised servicers who are attracted to service and extract value from the high proportion of Italian NPLs seemingly owing by SMEs. Servicing is likely to be expensive and more challenging than in other jurisdictions. The NPLs are not going to be concentrated in the real estate sector (unlike in Ireland or Spain, for example). This could, at least initially, have a depressive affect on NPL values, as well as increasing investor costs, further adding to the difficulties in establishing a viable NPL market. However, at the same time, the difficulties create significant opportunities for those looking to take advantage of a fragmented servicer market.

Both the ECB and the EBA have announced that they see the revival of the European securitisation market as a key component in the resolution of Italian banks' NPLs. The establishment of GACS will help in this regard. It remains to be seen how great investor interest will be to get involved with large-scale NPL securitisations given the increased cash flow risks, although appropriate liquidity facilities or over-collateralisation would help minimise concerns.



[2] Fee price increases over time to incentivise timely recoveries (first three years based on 3-yr CDS, followed by 5-yr CDS and then 7-yr CDS after five years).

In a positive sign, Banca Popolare di Bari recently completed the first large NPL portfolio securitisation benefiting from the GACS guarantee. Resort to GACS by Monte dei Paschi di Siena is a further example.

Italian NPLs continue to suffer from a lack of data quality affecting due diligence. If NPL prices are to increase, investors need to be able to assess exactly what it is they are buying and be provided with NPL information efficiently – preferably digitally. Improvements in this area would also better enable banks to package up their NPLs into appropriate bundles to suit the different interests and requirements of specialist NPL investors.

Private-backed Atlante funds: useful, if limited, ability to sweep up NPL debt

Atlante is a private-backed €4.2bn alternative investment fund set up in April 2016. Its aim is to act as a back-stop for Italian banks required by supervisors to raise capital and to buy-up the mezzanine and junior tranches issued by vehicles purchasing Italian bank NPL portfolios. Its resources were largely used up rescuing Banca Popolare di Venezia and Veneto Banca after initial cash calls attracted zero market interest. Atlante's management company has since launched a second fund to invest in NPLs only, early contributions being made from the first Atlante fund, with the aim of reaching €3-3.5bn by July 2017.

Impact of the reforms and ongoing challenges to Italian NPL disposals

Final remarks

Crucially, the Italian Government hopes that the reforms it has introduced so far will attract specialised foreign investors whose skill and experience it recognises are necessary to help clean-up Italy's NPL mess. Their success will need to be judged over the medium term where the legal reforms are generally expected to improve NPL recovery times and rates as well as making NPL cash flows more certain. The establishment of GACS and, to a lesser extent, the Atlante funds initiative, should also have a knock-on effect for the NPL market by stimulating an increase in prices reducing the bid/ask spread and encouraging NPL portfolio securitisations.

The Italian Government recognises that the legal and tax reforms will not have an immediate effect and that further measures will likely be needed. But, a preliminary assessment (based on a series of assumptions) carried out for the Bank of Italy suggests that:

> by 2020, bankruptcy proceedings could be completed in up to half the current time – from over six years down to three years; and

> judicial enforcement procedures could be reduced by about one year down to three years.

Such estimates may, of course, prove to be wrong. A survey conducted by the Italian Banking Association and Cerved (one of Italy's largest NPL servicers) in November 2015 concluded that there would be a reduction in the average length of bankruptcy proceedings by about one year. Even so, research for the Bank of Italy notes that just a one year reduction in recovery time should increase NPL prices by 4.6% of their gross book value.

Three years to enforce security collateral is still a long time in comparison with the UK or U.S. Given the number of legacy NPLs the court system would also simply not be able to cope – consensual restructurings (out-of-court) will need to play a vital role. In addition, Italian insolvency and enforcement procedures remain highly complex even after the reforms and the many different variations continue to make it hard to predict with any certainty recovery times and values.

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