EUROPEAN NPL 2019 REVIEW AND OUTLOOK: European banks' NPL stockpiles decline steadily in 2019; Greece set to lead 2020 charge with multi-billion-euro reduction plans.

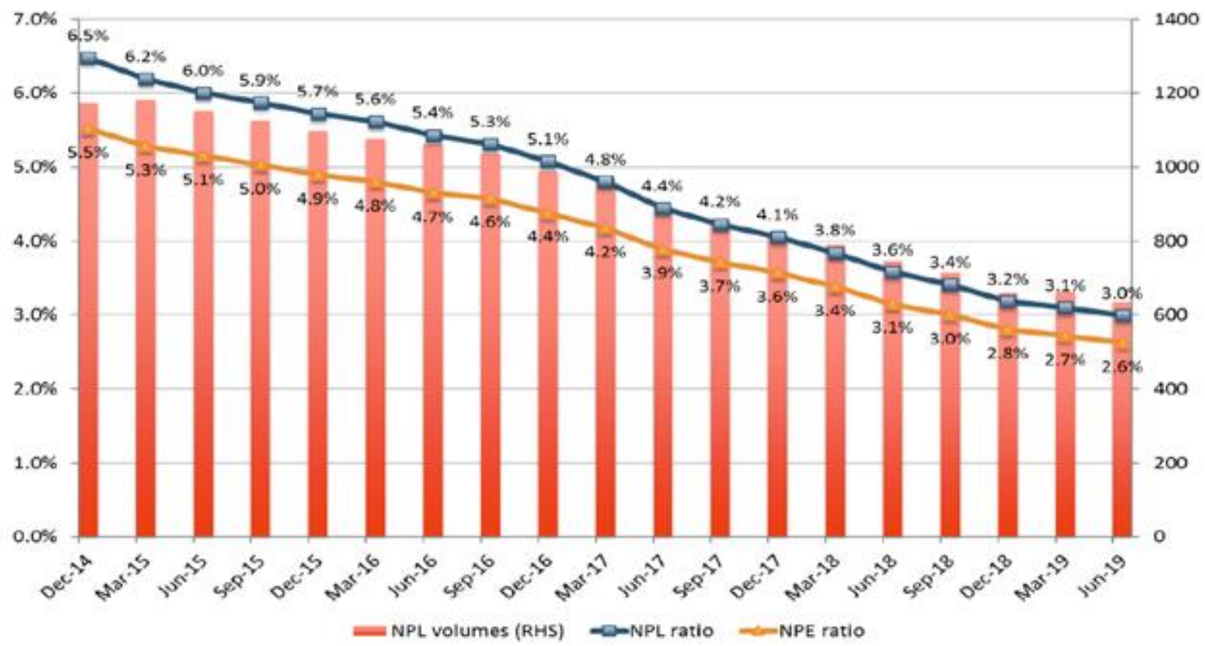
CapitalStructure

Stocks of non-performing loans (NPL) in the European Union banking sector continued their steady march downwards in 2019: current volumes now stand at c.€636bn, down from a peak of €1.15trn in June 2015. According to Deloitte, overall sales in 2019 will be down 30% on the previous year's record €202bn total. Nevertheless, 2020 promises to be very busy, and Greek systemic banks look set to lead the charge with multi-billion-euro 'mega deals'.

Greece's parliament has recently approved a securitisation-based asset protection scheme, which is expected to bolster activity in the New Year. Meanwhile investors can expect to see a nascent market for NPL ABS in Spain, alongside continued deal flow from Portugal and Ireland. The Italian market, which was somewhat quieter this year compared with 2018, is by no means out of the picture, with UTP sales and more NPL securitisations in the pipeline.

But despite securitisation's pivotal role in the deleveraging of Europe's banks, there remains a dichotomy between what regulators demand of banks in terms of NPL reduction targets and what EU securitisation rules dictate: current securitisation legislation is making it difficult for potential issuers of NPL securitisations to comply – and a recent Opinion Piece from the EBA recommending various amendments to the Capital Requirements Regulation (CRR) as well as to the Securitisation Regulation underlined this. The ball now lies in the EC's court.

Quarterly trend in NPL and NPE ratios (%) and NPL volumes (€bn) — December 2014 to June 2019



Source: EBA

Approximately €27.3bn (gross book value) of European NPLs and RPLs (re-performing loans) were securitised in publicly rated deals in 2019 (as of 17 December):

Deal name	Originator/seller	Portfolio GBV (€m)	Region/deal type	Completion Date
Leviticus SPV	Banco BPM	7400.00	Italy/GACS	February
Juno 2	Banca Nazionale del Lavoro	968.00	Italy/GACS	February
Jepson Residential	Lone Star	620.00	Ireland/Refi	March
Pillar Finance DAC	Eurobank	2000.00	Greece	May
Gaia Finance	Montepio	234.30	Portugal	May
ProSil Acquisition/Salduero	KKR	494.70	Spain	July
ERLS 2019-NPL1	Lone Star	458.87	Ireland	July
ERLS 2019-PL1	Lone Star	675.90	Ireland	October
Prisma SPV	UniCredit	6000.00	Italy/GACS	November
ERLS 2019-NPL2	Lone Star	1330.00	Ireland	November
Marathon SPV	Hoist Finance	5000.00	Italy/Reg Cap trade	December
Iseo SPV	Ubi Banca	857.60	Italy/GACS	December
Futura 2019	Guber Banca	1260.00	Italy/non-GACS	December

Source: CapitalStructure

ITALY

Activity to pick up following 2019 lull

The pace of deal flow in the Italian market slowed in 2019 – particularly in comparison with 2018. While a mammoth €200bn in NPLs have been divested over the past five years, banks still hold around €220bn in NPLs and UTPs (unlikely-to-pay loan) on their balance sheets. Several securitisation deals are expected to close before the year is out (some with the GACS guarantee, some without) and several more are expected in 2020. UTPs are also expected to be a key focus for banks.

Harish Kumar, managing director at Alvarez & Marsal, said the lull in activity in the Italian market experienced in 2019 was partly due to market participants getting to grips with UTP loans, which now represent the lion's share of NPE stock left on Italian banks' books.

"UTPs are a very different breed to NPLs and specific to the Italian market: The whole NPL ecosystem is having to adapt to understand, value and provision for these loans," said Mr. Kumar. "But activity is picking up rapidly. Banks are sitting on a huge stock of UTPs, and regulatory and accounting pressures mean that the banks will have to deal with them sooner rather than later."

Mr. Kumar said he saw scope for a combination of direct sales and securitisations in 2020. Given the deleveraging pressure as well as recent efforts in facilitating the UTP secondary market, he has observed large and smaller banks looking for avenues to dispose of stock. "As the UTP is a very complex asset class, investors are carefully looking for the right strategies and ways to overcome current market challenges. But we observed few ice-breaking transactions (e.g. Intesa – Prelios) in 2019 and we anticipate the pace will pick up in 2020."

Under the agreement reached between Intesa Sanpaolo and Prelios, Prelios has been given a 10-year contract to service a c.€6.7bn GBV portfolio of Intesa's corporate and SME UTP loans.

Mr. Kumar also highlighted that as many UTPs could be currently misclassified, there will be a point when banks will have to correct classifications - i.e. a proportion of UTPs will have to be reclassified as bad loans.

GACS, non-GACS and re-performing deals anticipated

The Italian government formally approved a renewal of its state guarantee for senior tranches of NPL securitisations (the GACS) in March. The scheme was renewed for at least 24 months, but as anticipated, the new documentation contained some key changes, including more stringent targets for servicers and a higher rating cap for eligible tranches (Triple B rather than Triple B minus).

To date, just two transactions have closed (UniCredit's **Prisma SPV** and UBI Banca's **Iseo SPV**) since the GACS was renewed, but two further transactions (from Banco Popolare di Bari and Iccrea Banca) are due to close before year-end.

According to Norman Pepe, partner at Italian Legal Services, the GACS will continue to play an important role in the Italian NPL market in 2020. However, given the sub-performance of some existing transactions at this juncture, he expects investors to be more selective.

"Given that most of the toxic assets have been cleared from banks' balance sheets, focus should shift to new recovery strategies," he said. "The quantity of NPLs offloaded on the market in recent years and the relatively small number and size of servicers seem to have resulted in a significant backlog, which is pushing performance down. From this perspective, GACS deals could be reconsidered in their purpose."

Several completed GACS transactions are performing below initial expectations, with actual recoveries lower than those expected in servicers' initial business plans. Scope recently downgraded two tranches of **Popolare Bari NPLs 2017** and earlier in the year downgraded CreVal's **Elrond NPL**

2017 Srl. In the case of Elrond, aggregate gross collections (€141.2m as of 31 December 2018) were approximately 25% below the initial business plan. For BP Bari, aggregate gross collections were €21.1m versus original business plan expectations of €24.9m.

Possible trends for 2020, according to Mr. Pepe, include re-performing transactions and the resale of assets on the secondary market on a greater scale. In this latter scenario, the GACS deals could be used to aggregate assets and streamline a "wholesale" process on the primary market, he suggested. However, originators will probably be required to be more heavily involved in secondary trades as indemnity providers (by way of assignment of the benefit of R&W and other support).

"Some changes on the regulatory side will be also necessary to clarify that new article 7.1 ReoCo can be used in connection with the recovery of receivables acquired in the secondary market," said Mr. Pepe. "At present there are doubts that it can be, and this issue may result in the NPLs currently held by banks being less liquid and have an undesirable impact on pricing, and should be addressed as soon as possible."

A new initiative sponsored by ACLI (the Catholic association of Italian workers) in the social housing space could meanwhile spur a new breed of NPL securitisations in 2020.

Under the plans, known as Project Snowdrop, NPLs collateralised by residential real estate or commercial real estate used by small businesses would be sold to an SPV that would issue rated senior notes and unrated junior notes. Mr. Pepe explained that the SPV's ReoCo would acquire the real estate assets from the borrowers by assuming the relevant debt, while the borrowers continued to use the real estate assets as tenants and pay rent (with the right to purchase back the assets) to the ReoCo, which would in turn repay the debt to the SPV.

Originators, bank foundations and other public or private investors (such as pension funds or municipalities) would be able to invest in the notes, provided that de-recognition of the portfolio was achieved, Mr. Pepe said.

Other collateral could also feature in 2020 transactions: Scope Ratings predicts as much as €2bn in NP lease securitisations in the year ahead.