FEATURE: Issuance of GACS-guaranteed NPL ABS unlikely to gain momentum; NPL-hungry PE and hedge funds may refinance portfolios via ABS.

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When the Italian authorities decided last year that it was time for Italian banks to tackle their huge stock of non-performing loans (NPLs), securitisation was hailed as the way forward. Not much has happened since, but the infrastructure is now in place and many market participants think that the sales of NPL portfolios will pick up - with securitisation being just one component of the tool box.

The Italian government-created state guarantee for senior securitisation tranches (known as GACS, Garanzia sulla Cartolarizzazione delle Sofferenze) and two funds – Atlante I and II - were set up to invest in NPL deals. However, issuance of government-guaranteed NPL ABS has, to date, failed to materialise in a meaningful way. Just one transaction has closed (BP Bari), while a multi-billion euro NPL securitisation from Banca Monte dei Paschi (BMPS) did not succeed.

While it is anticipated that a small number of banks may still launch securitisations of NPLs before the year is over, deal volume is expected to be relatively small and initial forecasts of €10bn to €11bn in placed issuance seem unlikely.

Nevertheless, securitisation may still have a role to play in the Italian NPL market: private equity and hedge funds - currently prolific buyers of Italian NPLs - may refinance those portfolios in the European securitisation market in the coming months.

Norman Pepe, managing partner at the London office of Gitti and Partners, says the use of the GACS guarantee in future NPL securitisations is uncertain. However, he says the Italian NPL market remains very busy, with a number of investors looking at various financing options for NPL portfolios.

"Market intelligence suggests that there may be two or three more NPL ABS transactions, such as Banco Popolare di Vicenza or Veneto Banca, but whether they will obtain the GACS is uncertain," he said. "The legislation on GACS is due to expire soon and I don't expect that banks will be able to do deals in this timeframe, unless it is extended. Instead, banks may do 'pure financing' transactions with investment banks such as Mediobanca, Banca IMI, Deutsche Bank and Nomura."

In December, PwC estimated that €50bn worth of bad loans could be sold in Italy in 2017. Italy's gross value of non-performing loans is estimated at c.€360bn.

In a Viewpoint published in July 2016, Pimco looked at net non-performing exposures (NPEs), i.e. loans unlikely to pay in the future or that are currently past due, but are not yet bad enough to classify as NPLs, as opposed to "sofferenze" loans, which have already defaulted. Pimco sees the amount of NPEs at c.€197bn, compared with c.€87bn of sofferenze loans on a net basis. Of the NPEs, around 60% were concentrated in five banks: Intesa €33bn, UniCredit €38bn, MPS €24bn, BPIM/Milano €17bn, and UBI €10bn.

In December UniCredit agreed to sell to Fortress and PIMCO two portfolios of NPLs with a combined gross book value of €17.7bn - the portfolios were transferred to newly set up and independent entities in which UniCredit will retain a minority position. Market participants think a securitisation could emerge from these trades - or at least a partial securitisation of the portfolios. Prior to this deal with UniCredit, Fortress had acquired c.€22bn of NPLs in Italy since 2000. Fortress topped Italy's buyers league table in Deloitte's Deleveraging Europe 2016-2017 report, ahead of Pimco, AnaCap, Banca FIS and Kruk.

Meanwhile, Bain Capital Credit made its first foray into the Italian NPL market in February, with the purchase of Heta Asset Resolution Italia Srl.

Refinancing NPL portfolios in the ABS market

Hedge funds and private equity funds are actively buying Italian NPL portfolios. In this domain, securitisation is a key financing tool, in both buying the portfolios (most NPL portfolios are bought through an SPV for legal and structural benefits) and also potentially for refinancing the transactions at a later date.

Vaclav Vacikar, ABS analyst at Rabobank, says he expects to see the refinancing of NPL portfolios acquired by private equity firms in the securitisation market.

"This is a logical step for these firms and for the market," he says. "They have securitised legacy assets and more recently mortgage pools with less investor-friendly features like WAC caps. We have seen some Irish transactions. So the securitisation of such NPL portfolios would make sense."

This week the European ABS market absorbed Lone Star's ERLS NPL1, an RMBS backed by an Irish NPL portfolio of €419.8m.

Meanwhile Blackstone is gradually securitising a €6.4bn portfolio of Spanish residential mortgages (known as the Hercules portfolio), which was acquired from CatalunyaCaixa - €212m of the SRF 2016-1 RMBS was placed with investors in October 2016, and €316m of SRF 2017-1 was sold to investors in March 2017. These RMBS transactions are backed by reperfoming loans.

Mr. Vacikar added: "The sizes may be quite limited but they will benefit from the low supply of vanilla products like prime RMBS and the fact that economic fundamentals are improving, which is supportive for performance of the portfolios and recovery rates."

Valuation issues

Although GACS-guaranteed ABS have not been ruled out completely, issuers face a myriad of obstacles. These include the wide bid/ask gap between market price and book price for portfolios, as well as a lack of investor demand for securitised tranches from traditional ABS investors.

"Italian banks' difficulties in reducing NPLs stock are still linked to the distance between market price and book value," said Paulo Gabriele, head of banks and financial institutions, structured finance at Gruppo Finanziaria Internazionale. "Even if the gap is reducing, thanks to additional impairments required by regulators and by increased competition from investors, it is not manageable by banks' current capitalisation levels. This is both in terms of sale losses and additional capital absorption due to LGD model impact."

In Q1 2017 around €2.8bn of NPL transactions were completed, according to Banca IFIS' quarterly update on Italian NPLs (published 20 April). In all deals the price was below the threshold of 10% of face value, the report said.

"There's still a gap," agreed Giovanni Pini, a consultant who has previously worked at Moody's and Scope. "But under pressure from regulators, banks are willing to take more of a writedown on NPL portfolios: they are getting closer to the levels at which private equity firms are willing to buy."

Amelia Colvin, managing director and head of distressed and non-performing assets at Cadogan Securities, also said that counterparties are a lot more receptive to NPL disposals, thanks in part to the ECB's initiative for banks to be more transparent with their NPL disclosures.

"We're now seeing a lot more mixed portfolios of secured and non-secured trades being sold. We're also seeing larger single-name positions sold, which of course will not be securitised."

"Pricing is one of the key issues for investors considering NPL ABS," added Ms. Colvin. On a straight NPL sale, an investor can get a 12%-20% return, depending on leverage. In a securitisation the highest return an investor can expect is 10%-12%."

Gordon Alexander Kerr of Cobden Partners suggested that Italian banks are packaging up portfolios of loans that are probably worth 2c-5c on the euro, and handing them over at 33% of face value (based on the Bari deal) in order to get fresh euros from the ECB. "Should the volume of NPLs going through this system continue - potentially exponentially - it will ultimately lead to a debasement of the euro," he said.

Any possible ABS deal backed by NPLs is likely to be related to equity investors' appetite and expected returns, rather than to obtain senior/leverage from the ABS market.

"As research has confirmed, GACS may impact only relatively on the final portfolio sale price," said Mr. Gabriele. "NPLs deals remain, in my view, junior investor-driven deals, who will have to perform their own accurate due diligence rather than buying a pre-packed / ready-to-buy deal."

Other market participants are similarly cautious on their outlook for government-guaranteed NPL ABS from Italy. Pier Paolo Masenza, a partner and financial services deals leader at PwC, commented that GACS was intended to be the answer to Italy's NPL problems.

"In reality they were not a game-changer," he said. "Only one bank has used this guarantee until now. But we expect more banks to securitise NPL portfolios going forward and possibly to use GACS."

It is anticipated that any government-supported deal will be sized around €1bn gross book value (GBV) and will involve some of the most troubled Italian banks. Mr. Gabriele said that in terms of portfolio selections and use of GACS, there will be probably a selection exercise aimed at maximising rating agencies' advance rate with an arbitrage exercise between rating methodology approach and market/servicers view, with more focus on secured portfolios.

"I would not exclude that GACS-guaranteed tranches will be retained by the seller banks since they will not absorb regulatory capital, and for many banks to have new funding is currently not an issue/requirement or at least GACS would not be the most efficient funding instrument."

According to Mr. Masenza, another reason why NPL ABS did not take off is because banks had to address several issues at the same time: one was improving banks' internal models at the request of the ECB.

"This focus on improving internal efficiency means that banks have had less time to focus on their NPL portfolios," he said. "But in the coming quarters, we are very likely to see banks dealing with these portfolios, using either securitisation or straight sales - or a combination of both."

Traditional ABS investors on the sidelines

GACS-backed NPL ABS do not easily sit in ABS funds. As UniCredit analysts recalled in their 2017 outlook, those NPL ABS are aimed at a "more specialised investor base willing to take risks".

The government guarantee could in principle give investors extra comfort, but it has the effect of reducing the spread, thereby making the investment less attractive.

Mr. Gabriele suggested that the choice to leverage the deal in the public ABS market will depend strongly on funding needs and costs. "So far the GACS tranche in the only deal structured in Italy was retained by the originator, and therefore the guarantee was more of a capital arbitrage instrument rather than an investor-oriented one," he said.

An asset manager said his firm's ABS funds have no interest in GACS ABS at the moment, as the coupons they pay are not high enough. The senior note of the Bari NPL transaction that was eligible for the GACS scheme paid a coupon of E+50bps (for a rating of Baa1/BBB (high).

Investments tend, therefore, to be channelled through specialised NPL funds. "Our NPL funds invest directly in NPL portfolio or equity/mezzanine tranches of deals, so our return target is much higher compare to GACS products," he noted.

"The failed Banca Monte dei Paschi di Siena securitisation gives a good indication of the state of play in the Italian NPL ABS market," said Ms. Colvin. "Although there was a cornerstone investor in place for the deal, other subscriptions were necessary and the wider market showed no real interest."

"Given that both rating agencies rated the BP Bari transaction deal one notch higher than Italy's sovereign rating, why would anyone be incentivised to pay for the state guarantee on securitisation tranches?" Mr. Kerr added.

Valuing the bonds is also proving quite tricky and is even a major stumbling block for some ABS fund managers. This is because standard modelling in the ABS sector requires significant reliance on historical loss data and assumptions about the legal framework. In contrast, repayments in NPL deals depend on foreclosures rather than the borrowers' scheduled repayments. Estimating the actual recoveries can be difficult as they fluctuate over the lifetime of the deals - they tend to be higher in the first two years than in subsequent years, market sources said.

"For us it is important that there is some certainty about cashflows," said an ABS portfolio manager. "In order to achieve this, the deal must contain a guarantee or another sort of interest certainty measure. So, just securitising a 'workout' portfolio with a huge amount of credit enhancement would not make sense for us," he added.

Because of the importance of recoveries, the investors' income stream depends on the efficiency of the servicer. "An incentivised servicer is able to add value to the recovery process, even more so for unsecured portfolios," Morgan Stanley analysts commented in their 2017 outlook.

This view was echoed by another ABS portfolio manager, who pointed out that "investors are highly exposed to the quality of the servicer and how the servicer is incentivised."

In his view, for the GACS guarantee scheme to work, the bank selling the NPLs needs the securitisation to be priced with fairly low margins; however, given the complexity and riskiness of the deals, investors in the securitisation require a much higher margin on the notes issued by the securitisation.

Another issue highlighted by a fund manager is that funds, especially those that are UCITS-compliant, need valuations. Investing in the subordinated tranches of NPL ABS deals would probably be attractive in terms of return, but getting valuations from independent quote providers is less certain - prompting him to keep away from the first Bari NPL deal.

Another investor thinks NPL ABS could be a suitable investment, but says some prerequisites should be met e.g. transparent base case Expected Recovery Curves and stress case with evidence of historical performance.

"The GACS structure on the one hand could give impetus for NPL issuance in Italy, yet the structure makes mezzanine rather back-loaded in terms of cash flows and also more exposed to the tail (higher risk) of the NPL portfolio," he said. "This could hold back ABS investors from buying mezzanine Italian NPL ABS. "

At his firm, for instance, the senior guaranteed structure would not fit the ABS mandate as the yield is too low; therefore, only the mezzanine, and potentially the equity, could be considered.

NLP ABS mechanics

Italy put in place a series of measures aimed at helping domestic banks take non-performing loans off their balance sheets, while implementing legal reforms to reduce the length of the recovery process - Italian foreclosures processes being widely viewed as excessively long.

The two key planks of the Italian framework were the creation of a state-guarantee for the senior tranches of NPL ABS, known as GACS; and the setting up of special funds Atlante and Atlante II, managed by Italian asset manager Quaestio Capital.

Atlante is a recapitalisation fund, with a bucket for NPLs. At least 30% of Atlante must be invested in NPLs from several Italian banks (via the purchase of junior tranches, occasionally mezzanine, in the securitisation of NPLs; SPVs etc.). After 30 June 2017, the portion of the fund not invested in banks can be invested in NPLs (presentation here).

Atlante II invests in junior and mezzanine tranches, issued by vehicles set up to acquire portfolios of NPLs of several Italian banks, with an objective of return in line with Single B bonds.

In the case of the NPL securitisation planned by Banca Monte dei Paschi di Siena, c.€6bn of senior notes were to be placed with investors and were to be potentially eligible and assisted, for the investment-grade component, by the government-backed GACS; up to c.€1.6bn of mezzanine notes were to be underwritten by the Atlante Fund. Finally, a junior tranche of up to c.€1.6bn was to be assigned to the shareholders of BMPS, in order to achieve simultaneous derecognition of the bad loan portfolio from the BMPS balance sheet.

This MPS deal is understood to have failed due to lack of investor demand.

The only partly successful Italian NPL ABS was Popolare Bari NPLs 2016. The €126.5m senior tranche, which was eligible for GACS, is understood to have been retained and repoed. Davidson Kempner bought the junior and the mezzanine notes. This Bari portfolio was securitised at 31% of gross book value (GBV) - 26% of GBV for the senior tranche - which was similar to what was seen in the pre-crisis Italian NPL transactions, Morgan Stanley analysts noted. However, the same analysts felt that this Bari deal was unlikely to serve as a benchmark for NPL 2.0 deals since over 63% of the collateral was secured (albeit in south Italy) and loan level data was available for investor analysis. There may also have been some degree of 'cherry-picking' of NPLs. "All forthcoming 2.0 ABS may not be able to achieve a similar outcome," the analysts noted.

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