Structured Finance - Market Commentary -

SF Performing

European NPL 2018 Review and Outlook: More variety of NPL collateral on offer as banks redouble efforts to cut exposures.

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Banks across Europe made significant efforts towards lowering non-performing exposures during 2018 and as a result investors were privy to an expanding range of portfolio sales and securitisations from different European jurisdictions. This included a steady flow of GACS-guaranteed NPL securitisations and the first unlikely-to-pay (UTP) portfolio sales from Italy; the emergence of secured sales from a maturing Greek NPL market; and continued deal flow from Portugal, Spain and Ireland.

According to the Banking Union's latest report on risk reduction, NPLs across the union stood at €820bn by the end of Q2 2018, down from a total of €950bn at the end of 2017 according to ECB data. But uneven NPL ratios persist across the EU, ranging from 0.6% to 44.9%, and slow progress in some member states remains a source of concern for the regulators.

With Europe's NPL problem far from over, 2019 promises healthy deal flow and increasing innovation from issuers and governments as they seek to cut exposures.

ITALY

Sustained flow of GACS transactions; first sales of UTP portfolios completed

The Italian NPL market remained buoyant in 2018 with a variety of portfolio sales, GACS securitisations and large-scale servicing M&A operations dominating deal flow. As of November 2018, €68bn in NPE transactions had closed: according to PwC Italia, the final tally for the year is likely to surpass €70bn. The activity in NPL sales and securitisations, however, was overshadowed by a volatile political situation.

According to Giovanni Bossi, CEO of Banca IFIS, the increase in yields on Italian government securities, with an associated increase in the perception of "Italian risk" in addition to increasing collection costs, makes the disposal of impaired loans more expensive for banks – which, in simple terms, means that it reduces the portfolio sale price.

"During the course of this year, and especially in the last few months, thanks to the increase in the spread, we noticed the loss of appetite by international operators for NPLs," said Mr. Bossi. "In spite of the macro trends we are dealing with a situation, which, in our opinion, is physiological and has not affected the operations of those who had already invested in platforms in Italy."

Transactions of note in 2018 included the long-anticipated €24.1bn (GBV) GACS guaranteed securitisation from Banca Monte dei Paschi di Siena, **Siena NPL 2018**, which was completed in May, while Intrum and Banca Intesa's multi-billion servicing joint venture and NPL transfer caught the market's attention.

The first sales of 'pure' unlikely-to-pay (UTP) portfolios hit the market in 2018, as this subcategory of non-performing exposures came under increasing focus from banks. As at June 2018 Bad Loans (sofferenze) volumes totalled €130bn (GBV) while UTP exposures reached €86bn (GBV), definitively surpassing the level of Bad Loans in terms of net book value (NBV) (€53bn vs €42bn respectively), PwC noted.

UTP portfolio sales included a €400m GBV portfolio of UTPs from Banca Carige known as **Project Isabella** and the €450m **Project Valery** from Credit Agricole Cariparma. Bain Capital bought both portfolios.

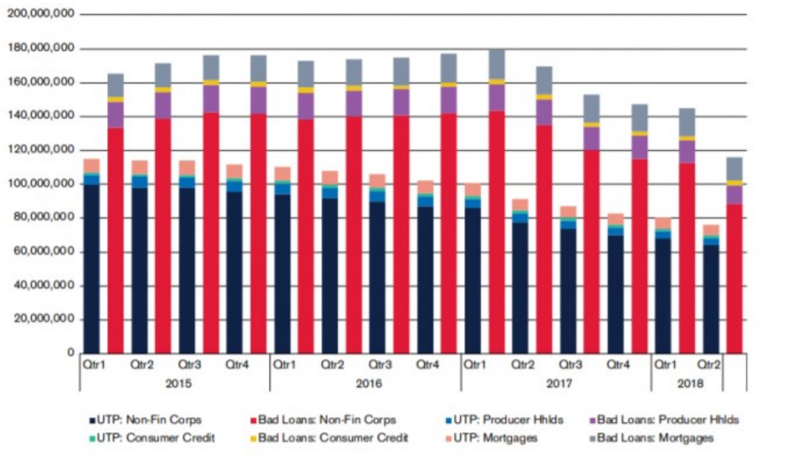
NPL ABS transactions completed in 2018:

Deal name	Bank	Size (GBV)	Total ABS issued
Siena NPL 2018	Banca Monte dei Paschi di Siena	€24,071.8m	€4,330.8m
Aragorn	Credito Valtellinese	€1,671m	€589.3m
Red Sea SPV	Banco BPM	€5,096m	€1,860.0m
4Mori	Banco di Sardegna	€1.04bn	€253m
2Worlds	Banco Desio	€1bn	€327.7m
BCC NPLS 2018	Iccrea Banca	€1bn	€323.9m
Maggese	Cassa di Risparmio di Asti	€697.2m	€ 206.6m
Juno 1	BNL	€957m	€163.9m
Maior NPL	UBI Banca	€2.75bn	€715.4m
AQUI SPV	Banca Popolare Emilia Romagna	€2.082bn	€618.4m
POP NPLs 2018	BP Bari +16 others	€1.578bn	€491.78m
Riviera NPL Srl	Banca Carige	€964m	€215m

As the flow of NPL securitisations from Italy increased, so too did deal innovation. Banca Monte dei Paschi di Siena's €24.1bn securitisation was the first to use a Real Estate Operating Company (ReoCo), which can bid for assets at auctions, and the use of multiple special servicers. Multi-originator deals also came to the fore, whereby smaller banks were able to pool NPL exposures and share economies of scale. For example, 17 Italian banks collaborated on **POP NPLs 2018.** While the banks shared the costs, the transaction itself benefited from more diversified NPL portfolios on a regional and/or sectoral basis.

In August the European Commission approved a six-month extension to Italy's GACS guarantee. The guarantee is now due to expire in its current form in March 2019, but it is anticipated that a new guarantee scheme is likely in the near future with an expanded range of assets - including UTPs.

Italian non-performing exposures by type:



Sources: Banca D'Italia and DBRS.

More GACS deals expected; rated non-GACS transactions under construction

A combination of GACS-guaranteed transactions, portfolio sales and the emergence of non-GACS NPL securitisations is expected to shape supply in the coming year. But according to Norman Pepe, partner at Italian Legal Services, the outlook for the Italian NPL market in 2019 is uncertain and will be largely dependent on what happens to the price of government bonds - the price of a GACS guarantee being based on a basket of single-name CDS on Italian issuers.

"If the GACS guarantee becomes too expensive as a result of price rises in this sector then outright NPL sales could become a more likely option for banks," he said.

Alongside any potential GACS NPL ABS issuance, Mr. Pepe said he expects to see some rated NPL securitisations that do not require a GACS guarantee - in these cases investors may be looking to optimise their existing portfolios through securitisation.

David Bergman, head of the structured finance team in Milan at Scope Ratings, said he expects there will be a few GACS-guaranteed NPL securitisations in January or early February 2019, ahead of the scheme's expiry in March. Mr. Bergman also suggested that investors may look at options in 2019 to secure new funding for NPL portfolios that they have already acquired. "This could take the form of securitisations - rated or unrated - and could be similar to some of the NPL securitisations that have come from Ireland in the past couple of years," he said.

Banca Carige was this week in the process of closing its second NPL ABS, called Riviera NPL Srl, which is backed by a bad loan portfolio with a GBV of €964m. Among the GACS deals expected to close in the new year, a transaction from **Iccrea Banca** is expected to reference NPLs from as many as 70 Italian cooperative banks. A second GACS issuance from **Banca Nazionale del Lavoro** and a deal referencing the portfolio of NPL assets included in the **Intesa/Intrum** partnership, which took place earlier this year, are also rumoured.

Mr. Bossi said he expects an increase in the volumes transacted by the smaller banks (second and third-level banks) that have not yet appeared on the primary market, and a further opening of the secondary market, especially in the second half of 2019.

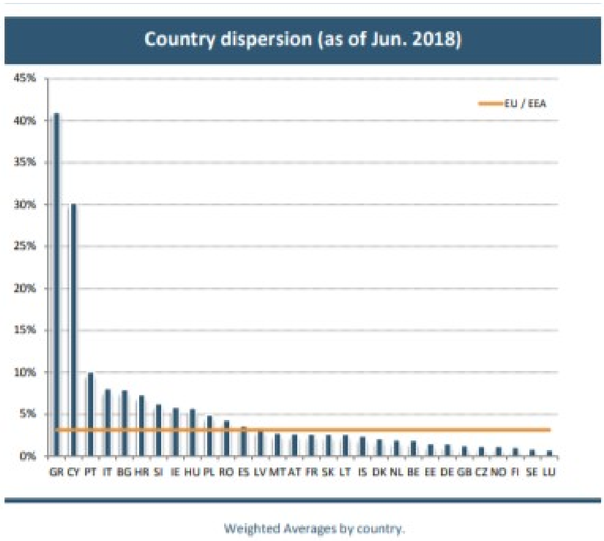
"Given the volumes transacted in this two-year period, we expect a decrease in absolute terms of the volumes of sales on the primary market and more movement in the secondary sector," said Mr. Bossi. "In 2019 we expect transactions for c.€40bn, of which around 25% will be in the secondary market. We expect many mixed portfolios to reach the market, especially if they are sold by smaller banks."

The performance of outstanding rated NPL securitisations is also something that is likely to come under more scrutiny next year, Mr. Bergman noted, as more data become available. "At the moment it is too early to tell," he said, "although some deals seem to be performing better than others".

GREECE and CYPRUS

Portfolio sales gain traction as investor interest ramps up

Greek and Cypriot banks are responsible for the two highest NPL ratios in Europe and were therefore very much in the regulatory spotlight during 2018. However, thanks to a combination of legislative reforms and appetite from global investors, positive momentum began to gather in the region. An accelerating flow of unsecured and the emergence of secured NPL deals came from the four Greek systemic banks - Eurobank, Alpha Bank, National Bank of Greece and Piraeus Bank - with increasingly competitive bid processes.



Source: EBA Risk Dashboard

These included Piraeus Bank's €1.45bn (GBV) **Project Amoeba**, the first commercial real-estate backed NPE sale in Greece. The same bank also sold an unsecured NPL portfolio known as **Project Arctos**, consisting of retail, non-performing unsecured NPLs. The National Bank of Greece sold its **Project Earth** portfolio of non-performing unsecured retail and small business loans to a consortium of CarVal Investors and Intrum; Alpha Bank meanwhile sold a c.€800m secured NPL portfolio known as **Project Jupiter** to Apollo, and its unsecured €2bn **Project Mercury** portfolio to Hoist Finance. Eurobank's **Project Zenith** - a €2bn unsecured portfolio - was sold to a consortium of B2Holdings and Waterfall Asset Management. The Bank of Cyprus Holdings meanwhile sold a secured real-estate NPE portfolio known as **Project Helix** to Apollo.

"Projects Amoeba and Jupiter in Greece as well as Project Helix in Cyprus showed that the demand exists for large NPL portfolios from the region," said Tassos Kotzanastassis, founder and managing director of 8G Capital Partners. "Investors are drawn to the Greek and Cypriot NPL market at present due to the fact that there are a number of sales in the works - given the pressure that SSM is exerting on banks to reduce their NPLs - and also because NPL opportunities in the rest of Europe are deemed too expensive or lacking in sales flow."

Two large-scale initiatives are under consideration to further cut Greek NPL exposures. In November the Bank of Greece unveiled a proposal to transfer a significant part of banks' NPEs, along with part of the banks' deferred tax credits (DTCs), to an SPV that could issue securitised notes (senior, mezzanine, subordinated junior/equity). The subordinated tranche will be subscribed by banks (each participating for no more than 20%) and the Greek State. It is anticipated that private investors will buy senior notes and a large portion of the mezzanine tranche. The Hellenic Stability Fund meanwhile has proposed the creation of a vehicle funded in part by the Greek State and/or with Greek State guarantees - similar to the Italian government's GACS scheme.

Large-scale government initiatives take shape; securitisations debated

According to Virginia Murray, partner at Watson Farley & Williams, there will be some big Greek NPL transactions in 2019, including secured NPL sales from all four banks, and an increasing number of auctions: banks are predicting that 18,000 auctions will have taken place in 2018 and up to 30,000 will occur in 2019.

"We are also seeing more cooperation between banks to rationalise debts; banks are selling their minority loan positions to the lead lender so that restructuring and enforcement decisions are easier to take," Ms. Murray said. "We may also see some sort of co-funding or other form of State assistance on the Cypriot model or other protection for low-value primary residences."

Alongside direct portfolio sales - of which there could be as many as 10 over the next 18-24 months - the viability of public securitised issuance backed by Greek NPLs is also under consideration. Eurobank has indicated it plans to securitise a €2bn non-performing mortgage book, as well as a c.€7bn securitisation of 'deep delinquency' NPEs following its merger with Grivalia Properties. The securitisation is expected to result in the issuance of senior, mezzanine and junior notes, initially to be fully retained, but with potential for mezzanine and junior notes to be distributed to shareholders, third-party investors, or a combination of the two at a later date.

"I am confident that before too long we will see a public NPL securitisation from Greece, but right now I don't think the market is mature enough," said Apostolos Gkoutzinis, partner at Millbank. "Private investors have just started signing and closing major transactions privately. The next step will be the public offering of securities backed by NPLs, but this is further down the line, after a few private deals have been done and the local market has been tested."

Mr. Gkoutzinis added that it could be counter-productive to go to the public markets too soon, risking heavier discounts than the NPL portfolios warrant - something that the Greek banks as originators would not want to see.

Mr. Gkoutzinis said he expects the Greek NPL market in 2019 to be characterised by more portfolio sales and broad servicing contracts, including situations where banks want to outsource some of these activities. The main challenge for investors remains the Greek legal and property registration system, he said.

“Many recent reforms have been in the right direction towards a more efficient and expeditious legal process. One of the biggest questions is how quickly the reforms that have been implemented manage to improve the reality of the court, land registry, legal and judicial systems.”

Concerns remain about the long foreclosure process in Greece: litigating against a Greek non-performing real estate borrower can take, on average, between 18 and 36 months for the asset to reach public auction and even then lenders have to confront other structural stumbling blocks - usually small populist political teams impeding the auction process, an investor noted.

“As an investor you will therefore have to accommodate three years in funding costs before realising any returns on your investment and in that timeframe there will be uncertainty over macro conditions and how they will evolve,” the investor said. “Greek banks have until recently avoided sales of secured portfolios because they know that investors will require a return of north of 15%-20% to make it worth their while.”

He added: “Success as an investor is not what price you pay for a portfolio, but how much you can collect subsequently. My concern is the lack of end-investors in the Greek or Cypriot market for repossessed properties, even with a 60% discount on market value. Right now the native Greek real estate consumer is not interested.”

IRELAND

Irish NPLs sales continue against political resistance

Irish banks continued with sales of NPL portfolios throughout the year, albeit against a background of increased political questioning of banks' practices and concerns about the servicing of the mortgages once sold.

Sales included Permanent TSB's portfolio, known as **Project Glas**, to the retail credit firm Start Mortgages, supported by LSF Irish Holdings 97 DAC - both affiliates of the Lone Star Funds. The bank also pre-placed a securitisation backed by mortgages classed as non-performing with investors called **Glenbeigh Securities**. Together the transactions will reduce the bank's NPL ratio to less than 10% from c.26% at 1 January 2018, PTSB said.

Allied Irish Bank (AIB) Group sold a NPL portfolio to Everyday Finance as part of a consortium arrangement with Everyday and affiliates of Cerberus Capital Management. The portfolio consisted of investment asset properties and excluded private dwelling houses and family farm homes. The portfolio was known in the market as **Project Redwood**, though at an Oireachtas Finance Committee held in March bank officials denied the existence of such a portfolio. **Ulster Bank** also sold a €1.4bn NPL mortgage portfolio to a purchaser managed by affiliates of **Cerberus Capital Management**. The portfolio consisted of approximately 2,300 private dwelling homes with a value of c.€615m and approximately 2,900 buy-to-let (BTL) homes with a value of c.€740m.

KBC Bank Ireland sold a €1.9bn NPL portfolio to Goldman Sachs comprising corporate NPLs and performing and non-performing UK buy-to-let loans.

Moody's said it expects more Irish NPL deals will emerge in 2019.

SPAIN and PORTUGAL

Spanish and Portuguese deals supported by healthy recovery backdrop

The healthy recovery backdrop and the better sovereign rating for Spain and Portugal (both upgraded this year) are likely to support the NPL disposal dynamic, according to research analysts from Morgan Stanley. Following record sales of NPLs this year in Portugal, the analysts expect momentum to continue in 2019.

Scope Rating's David Bergman suggested that there could be more NPL securitisations from Portugal (following this year's Guincho transaction from Banco Santander Totta) - although not necessarily rated deals.

Guincho Finance, an NPL securitisation backed by loans originated by Banco Santander Totta, closed in November following public marketing. The deal followed several months after JPMorgan sounded out investors for interest in either a securitisation of NPLs or a portfolio sale - securitisation being the preferred outcome.

Sales of Spanish NPLs continue, with totals as of H1 2018 at €75bn versus a peak of €232bn in 2013. Around 75% of the total NPL reduction has been achieved through internal actions and the remainder was the result of the transfer to SAREB, DBRS noted. According to the rating agency, most Spanish banks are approaching the European bank NPL average, although they do remain above pre-crisis levels, but the agency says it is less likely that Spanish banks will close sizeable NPL sale transactions. Rather, DBRS expects banks to seek the foreclosure of assets as the main way to recover NPLs.

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