



GACS tool in the Italian Non-Performing Loans space

**Main features, key evidences
and next market expectations**

Portfolio Solutions Group

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Foreword & Content



In this report, we identify and discuss the key features of the GACS tool that are taking centre stage in the Italian Non-Performing Loans ("NPL") landscape...

During the last three years, the Italian Non-Performing Loans market turned out to be the **most active in Europe**. Despite the **uncertainty in the economic scenario** (technical recession, increasing country risk and low interest rates), Italian banks have achieved a **significant reduction** in their **stock of non-performing exposures**, thanks to several market transactions (both straight sales and securitizations). However, at the end of 2018, the Italian **NPL ratio** equals to approximately **6.3%** (still high in comparison to other major European countries).

To date, the **GACS tool** has undoubtedly played the most relevant role, together with the reform of legal procedures, in banking deleveraging process. The "*Garanzia sulla Cartolarizzazione delle Sofferenze*" (GACS), introduced in February 2016 and extended several times until March 2019, envisages that the Italian State provides a guarantee on the **senior notes repayment in rated Non-Performing Loans securitization transactions**.

The guarantee's objective is to **reduce the bid-ask price spread** between originators (selling banks) and investors and **increase the number and the volume of NPL transactions**.

To date, **21 GACS transactions** have been completed, accounting for an overall gross volume approximately of € 62bn. However, preliminary analysis from Rating Agencies are showing that GACS transactions are **performing below initial expectations** (actual recoveries are lower than those expected in initial servicers'

business plans). The underperformance may be attributed to an underestimation of the **onboarding process** by the servicers, but at the moment future performances seem hardly predictable and a longer observation period may be needed.

The GACS tool has been **recently renewed** (in April 2019), for a period ranging from 24 to 36 months. The new GACS framework has envisaged some substantial amendments in order to make the **senior notes repayment more certain** and further tie the servicer's **compensation to the transaction's performance**.

In the light of the aforementioned considerations, we expect that the "new" GACS tool will entail a **high number of transactions** within the Non-Performing Loans space for the coming years, leading to **a further significant reduction of banks' NPL ratios**.

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A snapshot of Italian macroeconomics and NPL market



Macroeconomic scenario

Ongoing uncertainties on Italian economics

The Italian economy is showing signs of stagnation in 2019. Economic risks stem from the huge **public debt**, which could trigger renewed financial turbulence. 2019 will be a challenging year, given a **weaker economic environment**, the **persistent market volatility** and the protracted **lower interest rates**.

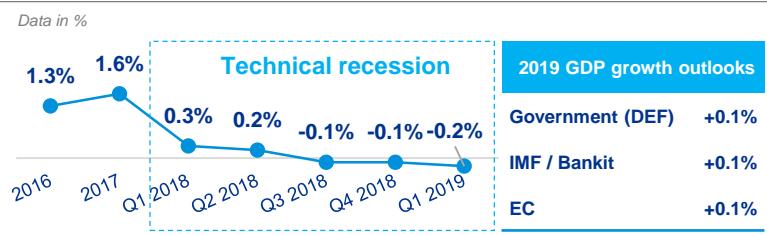
After peaking at 1.6% in 2017, real GDP Growth Rate has sharply **decreased**. Italy fell into technical recession in 2018, as the country's economy contracted for the second consecutive quarter, and BTP-Bund **Rate Spread** reached 270 bps in the first months of 2019.

The economic outlook for 2019 has been revised downward and, with the ECB interest rate evolution likely to be delayed to 2020, there is a high likelihood that **Euribor rates will remain at negative levels** for the following years.

Considering recent trends within the macroeconomic scenario, Rating Agencies have envisaged a negative outlook for Italian key economics and the **Italian Credit Rating has been gradually downgraded** (scaled down to **low medium grade range**).

This macroeconomic scenario has negatively impacted banks' profitability, especially for large intermediaries. In this challenging environment, Italian banks are expected to take **additional measures to reinforce their balance sheets and support profitability**.

Chart 1 - Real GDP Growth Rate



Source: The Economist Intelligence Unit

Chart 2 - BTP - Bund spread



Source: Bloomberg (figures as of 21/05/2019)

Chart 3 - Euribor 6M forward curve



Source: Bloomberg (figures as of 21/05/2019)

Chart 4 - Italy Credit Ratings

Rating Agencies	Rating	Outlook	Last Update	Action
Standard & Poor's	BBB	Negative	26/04/2019	Rating confirmation
Moody's Investors Service	Baa3	Stable	15/03/2019	Rating confirmation
Fitch Ratings	BBB	Negative	22/02/2019	Rating confirmation
DBRS	BBB +	Stable	11/01/2019	Rating confirmation

Source: Rating Agencies

NPL deleveraging across the Italian banks

NPL deleveraging through market tools

Since 2016, top Italian Banks reduced considerably their bad loans stocks through disposals and securitization transactions, with the **GACS tool** playing a leading role in overall NPL ratio reduction.

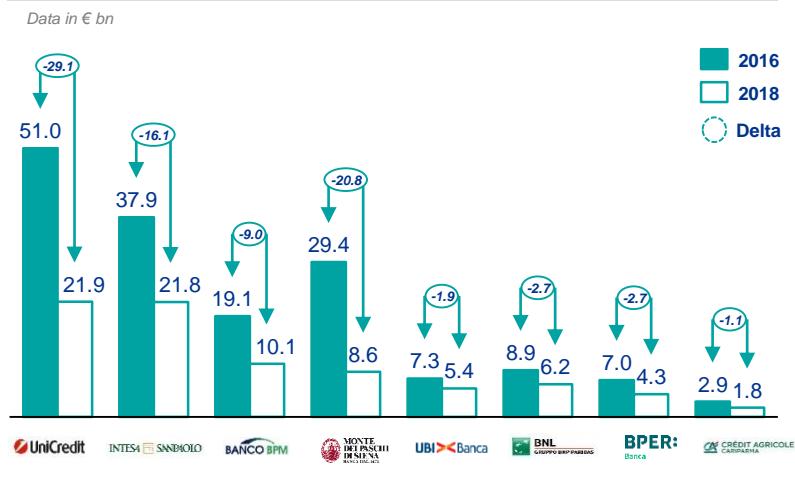
During 2018, several important NPL transactions took place in the Italian banking system. Among the others,

- **Unicredit** sold € 29.1bn bad loans portfolios to Pimco & Fortress;
- **Banca Monte dei Paschi di Siena** closed the disposal with GACS scheme of a € 24.0bn mixed secured - unsecured bad loans portfolio with Quaestio;
- **Intesa Sanpaolo** sold a bad loans portfolio accounting for € 10.8bn to Intrum.

Almost all the top Italian banks, except for Intesa Sanpaolo and Cariparma, have resorted to the **GACS tool** in their deleveraging strategies.

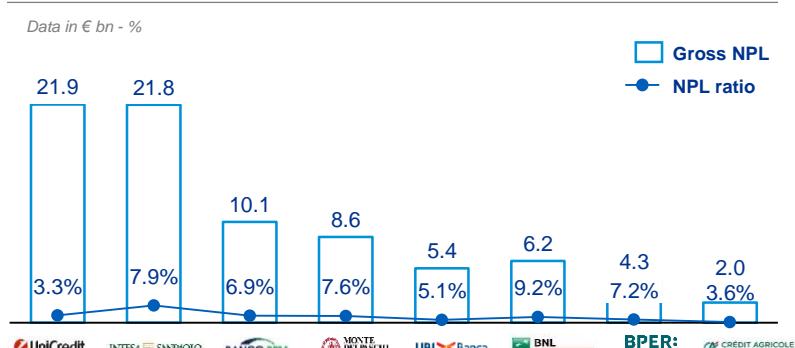
To date, Italian NPL gross volumes experienced a significant decrease but on average **NPL ratios are still too high compared to banks' targets**. However, with the adoption of **IFRS 9** (phase-in option), top Italian Banks have been **increasing their NPL coverage ratios**.

Chart 5 - Top 8 Italian Banks - Gross Bad Loans analysis



Source: KPMG elaborations on banks' financial reports as at 31/12/2018

Chart 6 - Top 8 Italian Banks - Gross NPL



Gross NPL Coverage Ratio

72.9% 67.2% 71.1% 62.4% 49.1% 62.9% 66.6% 68.4%

Source: KPMG elaborations on banks' financial reports as at 31/12/2018

The securitization tool across Europe

NPL securitization is not a new phenomenon in Europe

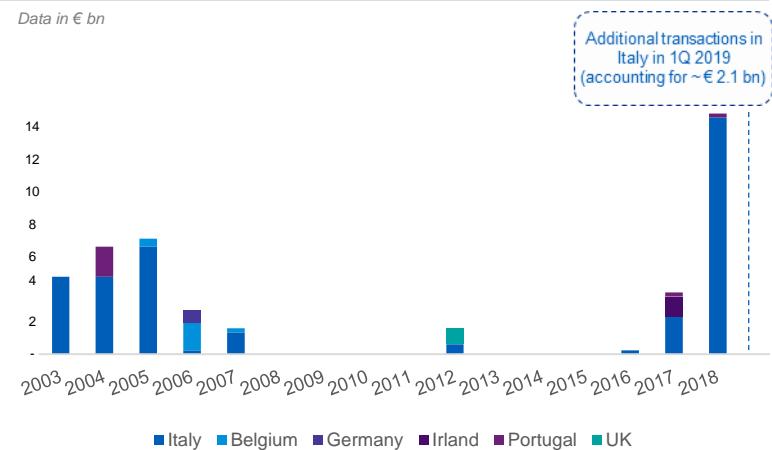
Transaction volume related to NPL securitizations was approximately € 4bn in 2003 and showed a slight growth in the following two years.

Since 2016 out of the total number of NPL securitizations closed in Europe, equal to 27, **21 securitizations have been recorded in Italy**, accounting for more than 80% of total European transactions volume.

Focusing on NPL securitizations in other countries, **Belgium (6%) and Ireland (5%)** ranked second and third in terms of 2018 volume of transactions.

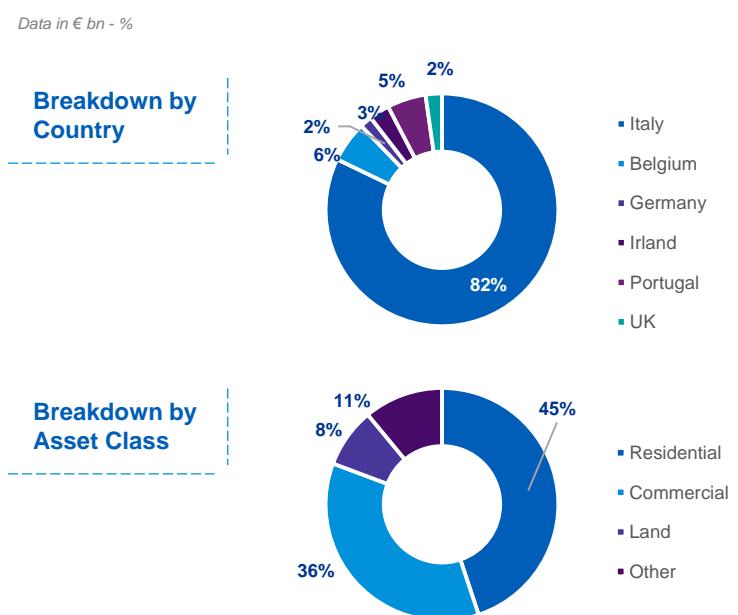
Residential loans ranked first among securitized asset classes, representing **45%** of total volume of transactions, while **commercial loans** ranked second, representing **36%** of total volume of transactions.

Chart 7 - Transaction Volumes in Europe (2003 - 2019)



Source: KPMG elaborations on DBRS data

Chart 8 - 2018 Volume of transactions breakdown



Source: KPMG elaborations on DBRS and internal data

GACS impacts on Italian NPL market

Analysis of Italian NPL trend from 2008 to 2019

In 2016 Italian banks' **NPE ratios started to decline**. This trend was driven by the largest banks which implemented an **aggressive deleveraging** to appease regulators and shareholders. Medium and small banks have then followed the tendency.

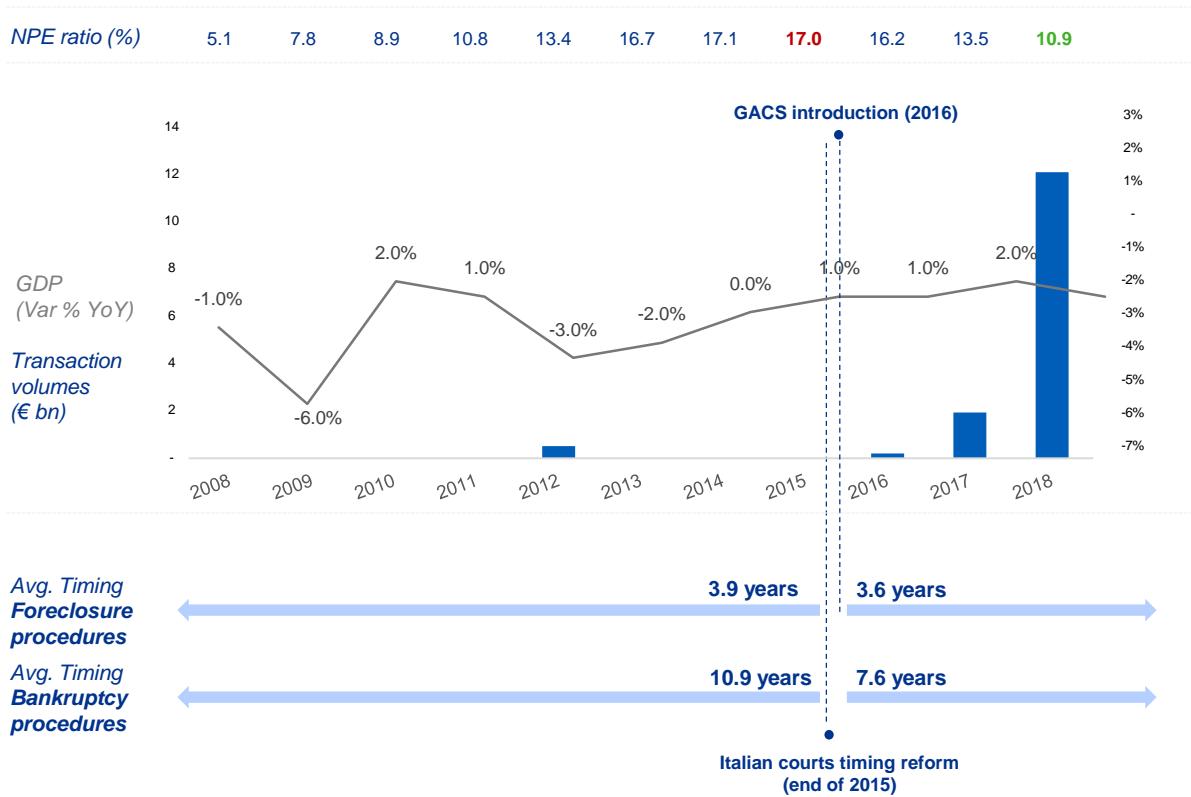
The deleveraging trend does not seem to have a **direct correlation with national macro-economics features**.

On the other hand, **courts timing reform at the**

end of 2015 and **Government guarantee on Senior Notes ("GACS")** introduction in 2016 had the **most relevant impacts on NPL stock reduction**.

Due to Italian courts timing reform and GACS introduction, **NPE ratio** in 2018 showed a significant reduction in comparison to the value reported at the end of 2015 (**from 17.0% to 10.9%**).

Chart 9 - GDP & transaction volume



Source: KPMG elaborations on DBRS, Economist Intelligence Unit ("EIU"), "Banca d'Italia", "Ministero Grazia e Giustizia" data

Overview of the GACS tool



GACS: key elements to keep in mind

Key elements of GACS transactions

Italian Banks

GACS may be granted if the securitization's underlying assets have been transferred by Banks having registered office in Italy...



The scheme provides for the granting of guarantees as part of securitization transactions whose underlying assets are bad loans...

Senior Notes

The State guarantee can be applied only to the Senior tranche of the securitization...



The price to be paid in relation to GACS shall be calculated on the basis of single name CDS related to Italian issuers with a risk level equal to that of the guaranteed securities...



BBB Rating

The State will issue the guarantee once the securities will have received a rating equal to or higher than BBB from an independent rating agency...



An independent servicer shall be appointed in order to manage the underlying portfolio and perform reporting activities.
Servicer monitoring mechanisms are envisaged by GACS regulation...



Guarantee enforcement

In case of default (even partial) of principal or interest repayment, GACS can be enforced by the holder within 9 months following the senior note's expiration...



GACS transactions are very attractive for Junior and Mezzanine Notes' investors as they require limited amount of resources

GACS introduction and key objectives

Implementation of the Italian non-performing loan state guarantee scheme

The Italian *Garanzia sulla Cartolarizzazione delle Sofferenze* ('GACS'), introduced by the Italian Government is a **mechanism to be used to facilitate the reduction of non-performing loans** from the books of commercial banks based in Italy.

The GACS tool was envisaged for the first time with the decree-law February 14, 2016, n. 18, and extended several times until 6 March 2019, when the existing GACS expired.

With the decree-law 25 March 2019 n. 22 ("Financial stability"), published on the Official Gazette of 25 March 2019 n. 71, the **GACS was renewed, with some modifications, for 24 months** (extendable for a further 12 months) starting from the positive decision of the European Commission.

The guarantee is granted by the Ministry of Economy and Finance ("MEF").

The GACS is issued as part of securitization transactions (Article 1 of Law 130/1999), **against the sale by the banks of non-performing loans to a Special Purpose Vehicle ("SPV")**.

The GACS guarantees **senior securities' holders against the non-payment of sums due for principal and interest**, and it is unconditional, irrevocable and on first request.

The European Commission agreed that the mechanism does not envisage any State aid, but, due to the restrictions on state aid, the **European Commission required the scheme to be only temporary and therefore needed to be renewed**.

The Ministry of the Economy and Finance set up a **Fund for the GACS**, as renewed on March 2019. The Fund is currently managed by Consap SpA and it has a financial commitment of € 220m, further fed by the annual fees for the guarantees granted from time to time.

Key objectives of the State Guarantee



Reducing the average funding rate for third party investors



Increasing investor reliance's upon securities (guaranteed by Italian Government)



Allowing for higher prices to originators



Cleaning up Banks' books from NPL exposures through a market tool

GACS transaction scheme

GACS transaction overview

The scheme envisages the presence of the State guarantees in securitization transactions whose underlying assets are **bad loans**.

The Bank proceeds with disposal of control and with NPL portfolio deleveraging. It can happen (i) through the sale of at least 50%+1 of Junior (and Mezzanine) Notes; (ii) with the sale of a significant portion of the Junior Tranche (and of the potential Mezzanine tranche).

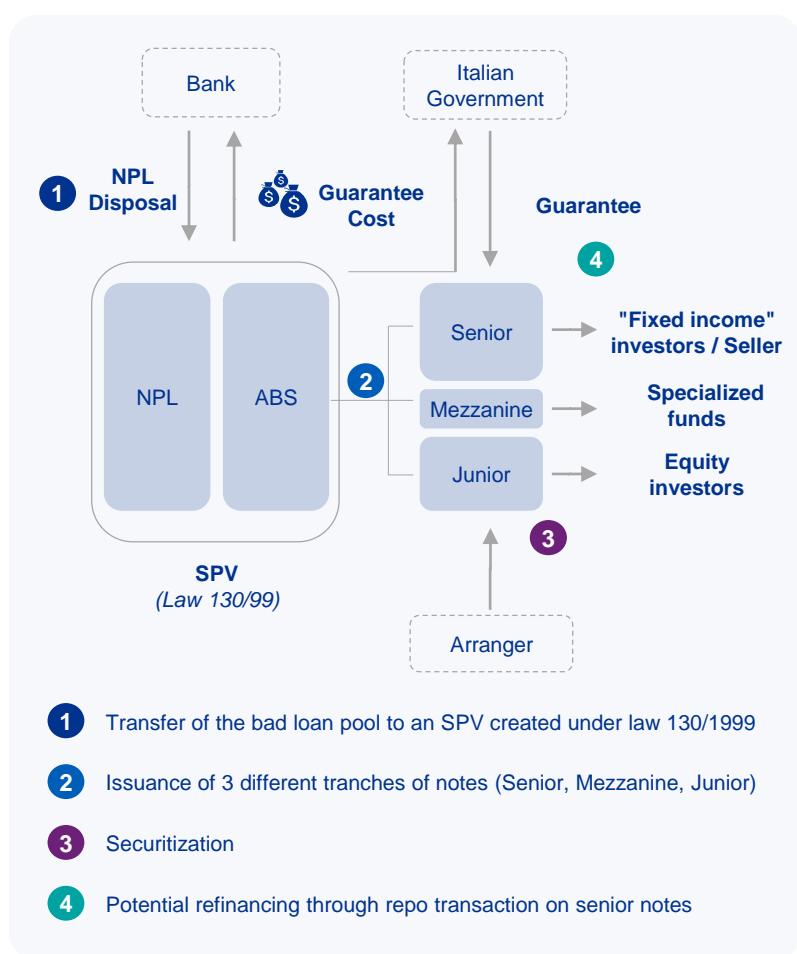
The State and related entities **cannot purchase Mezzanine and Junior Notes**.

The NPL portfolio must be disposed at a price **not higher than the Net Book Value** of the portfolio

The Government guarantees **only the senior tranches** of securitization transactions. The riskiest tranches (i.e. junior and mezzanine) will not be repaid until the senior tranches, guaranteed by the State, have been fully repaid.

The State will issue the guarantee once the securities will have received a **rating equal to or higher than BBB** from an independent rating agency accepted in the Eurosystem.

Chart 10 - Securitization deal with the GACS scheme



External rating will be **based on the following**: (i) cash flow analysis; (ii) collateral value analysis; (iii) credit quality of the underlying loans; (iv) invested amount in the more junior notes; (v) operating capacity of the special servicer.

Banks will be required to entrust credit recovery to an **external independent servicer** to prevent any conflict of interest from hampering debt recovery.

Sample capital structure of a GACS transaction

Requirements on capital structure

Tranching is determined within the closing of the transaction, following the analysis of the Rating Agencies. A potentially obtainable tranching could be the one depicted in **Chart 11**.

For the most part, senior and mezzanine securities will be **index-linked to 6ME**.

The overall **WACC** of a securitization transaction with GACS is around **4.0% - 4.5%**.

The **highest prices** in GACS transactions have been recorded for transactions involving **gross exposures in the range € 1-5 billions**.

Junior and Mezzanine investors could be able to benefit from the flows only as a result of the **total repayment of the Class A**, provided that the transaction may include interest payment mechanisms on senior Class B notes with respect to the payment of capital on Class A notes, possibly based on the performance trend of the transaction with respect to the Business Plan.

An example of waterfall of payments is showed in **Chart 12**.

The GACS scheme envisages the presence of a **liquidity line and a hedging provider**, in accordance with the criteria set by the rating agencies.

Chart 11 - Sample capital structure

Class	Rating	Note size (%)	Retention / pricing	Coupon	Retained / Market
A	[Baa2&BB]	[80-85%]	100%	6ME + spread	Retained
B	[B2/B]	[10-15%]	20%- 50%	6ME + spread	Market
J	NR	[5%]	0 - 5%	Variable return	Market

Source: KPMG elaborations on publicly available data

Chart 12 - Waterfall of payments

1	<u>Senior Expenses</u>
2	<u>Servicing fees</u>
3	Interest payment of the liquidity line
4	<u>Guarantee fees</u>
5	Swap payment
6	<u>Interest payment of Senior Notes</u>
7	Reconstitution of the liquidity line (if used)
8	Interest payment of the Mezzanine Notes (if present)
9	<u>Principal repayment of Senior Notes</u>
10	Principal repayment of Mezzanine Notes (if present)
11	<u>Distribution on Junior Notes</u> (once Senior and Mezzanine Notes have been fully repaid)

The new regulatory wave

Through the D.L. of 25th March 2019, the Italian government has renewed the GACS scheme, introducing some relevant updates and amendments...

Expiration date

New GACS will be released for a period of 24 months from the date of approval of the European Commission. A 12 months-extension period is envisaged.

Servicer substitution

After senior bondholder GACS enforcement, in case of two consecutive interest payment dates where the ratio between net cumulative recoveries and net recoveries expected in servicer's business plan is less than 100%, the servicer substitution is envisaged.

No penalties are due to the replaced servicer.

The new appointed servicer shall not have any connection with the former one.

Servicer payment

Any fee due to the servicer shall be subject to the achievement of performance goals connected with portfolio's recoveries.

Whenever, at any servicing fee payment date, the ratio between net cumulative recoveries and net recoveries expected in servicer's business plan is less than 90%, a portion not less than 20% of the total due fee shall be

deferred to the total reimbursement of senior note or to the date when the ratio returns greater than 100%.

Interest payment on mezzanine notes

Whenever the ratio between net cumulative recoveries and net recoveries estimated in the portfolio business plan is less than 90% at the mezzanine interest payment date, the related interest is deferred since the completion of the reimbursement of senior notes capital or since when the ratio is greater than 100%.

Rating issuance

The senior notes rating shall be equal to BBB or equivalent.

Guarantee Funding

The guarantee is funded by the annual payments coming from GACS issuance.

In 2019 it is envisaged an increase of the guarantee fund of approximately € 100m.

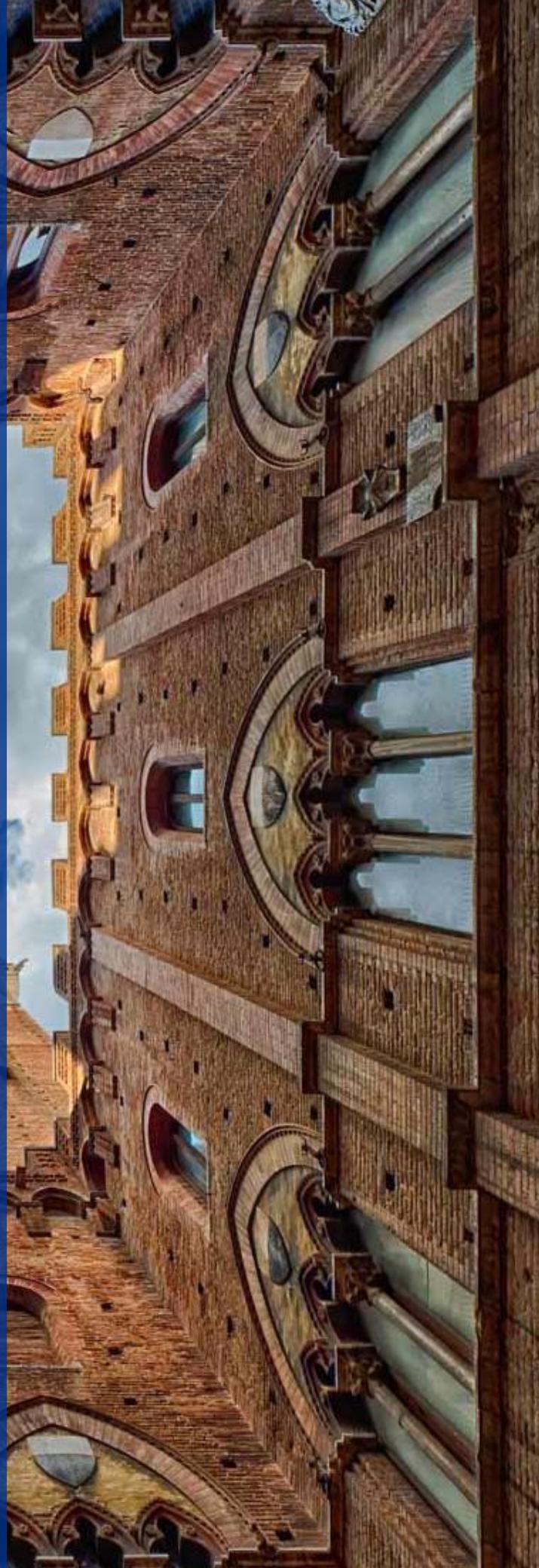
Costs related to monitoring the compliance of new GACS issuances with current regulatory framework are estimated to be equal to € 150k per year

Computation methodology for guarantee price

		Estimation GACS Fee
	Guarantee price	<ul style="list-style-type: none"> 6-month average of mid-prices of CDS included in the sample ("average of mid-prices") Arithmetic average of the averages of mid-prices
	Base Commission	Computed on the residual value of the senior tranche, based on following prices: <ul style="list-style-type: none"> Years 1, 2 and 3: price of the 3-year CDS sample Years 4 and 5: price of the 5-year CDS sample From year 6 onwards: price of the 7-year CDS sample
	Additional Commission⁽¹⁾	Applicable from year 4 to year 7, provided that the senior tranche has not been fully repaid <ul style="list-style-type: none"> Years 4 and 5: 2.76 times the difference between the 5-year CDS sample and the 3-year CDS sample Years 6 and 7: 9.23 times the difference between the 7-year CDS sample and the 5-year CDS sample

⁽¹⁾ The Additional Commission is computed on the basis of the following assumptions: (i) 2% discount rate and (ii) linear amortization of the senior tranche in 7 years

Focus on
completed GACS
deals



GACS deals: key features

Key recent dynamics

After GACS introduction, **21 transactions were completed** between 2016 and 2019 for a total **GBV of € 62.1 bn**; **9 deals** on total number of transactions had a deal size ranging from € 1 to 5bn.

Around **60% of securitized loans** are backed by mortgages on real estates properties.

In terms of GBV, the largest completed transaction has been **Siena NPL 2018** with a gross book value equal to **€ 24bn**.

Servicers' business plans reported **an average expected GDP** of about **35.6%** (in terms of GBV). Average haircut from rating agencies in phase of review has been equal to **20.8%**.

As shown in Chart 16, **the average tranching** has been about **85%** of senior notes.

Chart 13 - Main data

Tot. Deals: #21

Tot. GBV : € 62.1bn



Chart 14 - Key players involved

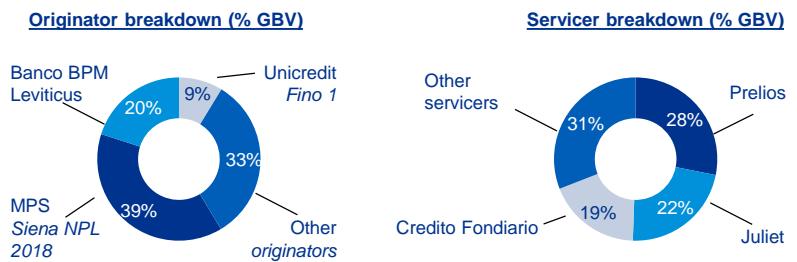


Chart 15 - Focus on expected recoveries

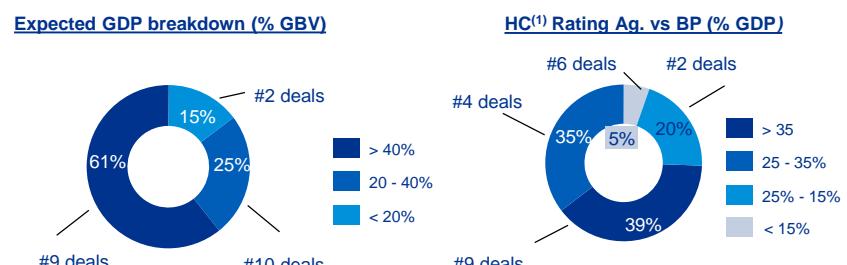
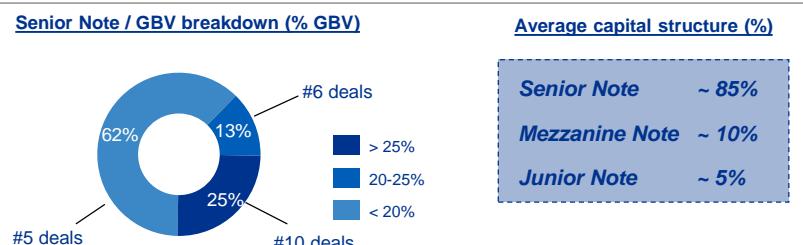


Chart 16 - Tranching



Source: KPMG elaborations on public reports issued by Rating Agencies

(1) Haircut

Main empirical evidences

The Italian State Guarantee has become an important boost to support banks in the execution of their deleveraging plans.

Here below some data and empirical evidences about these 3 years of GACS...

GACS deals snapshot

Borrower size

€ 200k - € 500k

Granular portfolios reduce the **concentration risk** and make the SPV less subject to potential downsides in cash flows.

As a result, Rating Agencies tend to **apply minor haircuts to servicer's recoveries.**

Secured Portfolio

30% - 77%

Highly secured portfolios **ensure a great advance rate on portfolio GBV** (generally, each 10% of secured GBV increases the advance rate in a range of 3.5 - 4.0%).

Chart 17 - % Secured on senior note (% GBV)¹

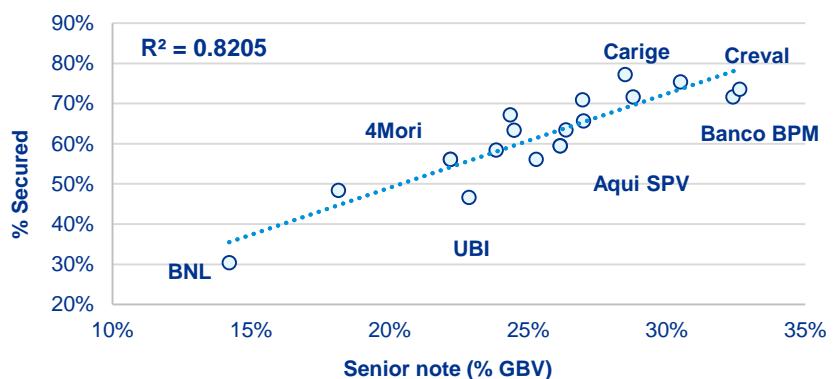
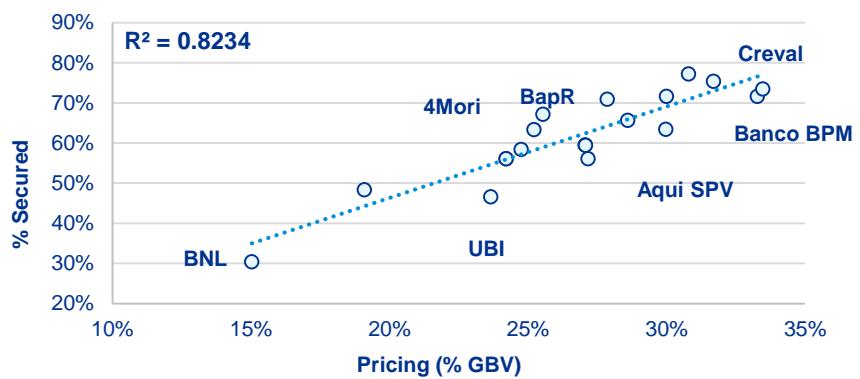


Chart 18 - % Secured on pricing (% GBV)¹



...the secured component, as a percentage of total Portfolio's GBV, is a key driver for capital structure and portfolio pricing.



Next market
expectations



Next market expectations

A very active GACS market in the coming years

To date, GACS mechanism has been greatly welcomed by Italian major banks and global institutional investors, leading to a **higher than expected** volume of transactions. However, **still high levels of NPL ratio** are pushing Italian banks to set new challenging targets for NPL reductions and continue the deleveraging process through market sales and securitizations.

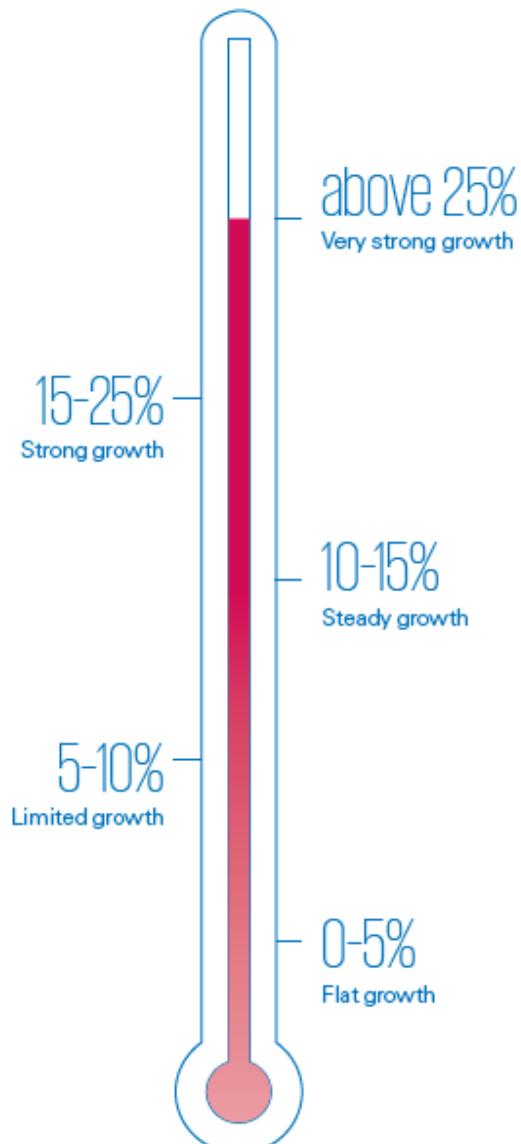
The **new regulatory wave** envisages the extension of the Government Guarantee for a further period of 24 - 36 months, while providing for a greater involvement of special servicers in coming transactions' performance (i.e. servicer substitution and servicing fee deferral mechanisms).

We expect these regulatory amendments to give further comfort to all the parties (i.e. banks / sellers, Italian Government, third party notes' investors) about the financial stability of the new transactions, leaving space for a **period of intense M&A activity in Italy**.

GACS transactions in **pipeline for 2019** already account for a gross exposure of approximately **€15bn**. Pipeline deals include both **multi-originator** transactions (pools of Italian mid-size popular and Cooperative banks), and single major banks' transactions.

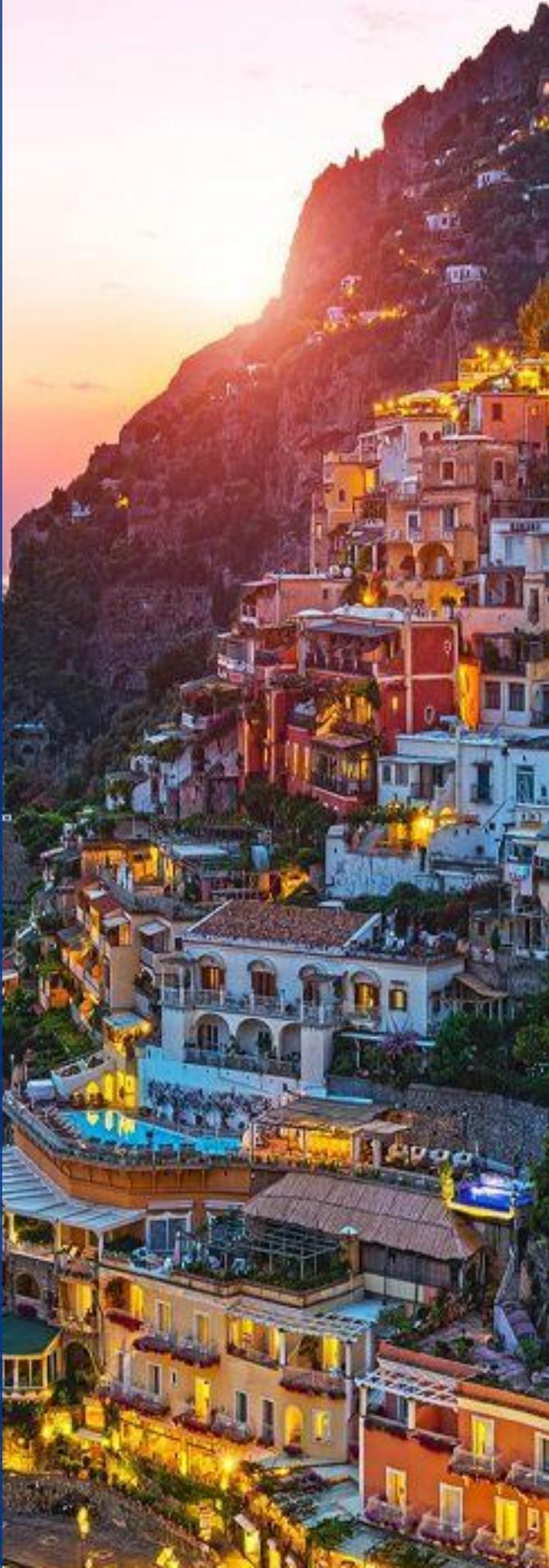
We expect a very active GACS market also **in 2020**, along with an increasingly interest from **new investors** seeking to access the Italian NPL market.

Figure 1 - Italy NPL M&A forecast



Annexes

List of completed GACS deals and key numbers



List of completed GACS with key features (1/2)

Chart 19 - Overview of the completed transactions

	Operation	Originator	Servicer	GBV (€ m)	Secured (% GBV)	OMV South (%)	OMV Resi (%)	Senior Note (% GBV, € m)
2019	Leviticus	Banco BPM	Credito Fondiario	7,385	 50.5%	 11.4%	 41.6%	19.5% (1,440)
	Juno 2	BNL	Prelios	968	 57.7%	 28.3%	 34.8%	21.1% (204)
	BCC NPLs 2018-2	Iccrea Banca	Italfondiario	2,004	 58.4%	 18.4%	 36.9%	23.9% (478)
	Riviera NPL	Banca Carige	Credito Fondiario	964	 48.4%	 8.4%	 40.6%	18.2% (175)
	Aqui SPV	BPB PER Banca	Prelios	2,082	 59.5%	 43.4%	 33.9%	26.2% (545)
	Pop NPLs 2018	Multioriginator	Cerved	1,578	 65.7%	 42.8%	 41.7%	27.0% (426)
	Ibla	BapR	Italfondiario	349	 67.2%	 99.7%	 57.8%	24.4% (85)
2018	Maior SPV	UBI Banca	Prelios	2,749	 46.6%	 22.9%	 57.3%	22.9% (629)
	Juno 1	BNL	Prelios	957	 30.4%	 21.3%	 29.2%	14.2% (136)
	Maggese	Banca di Asti	Prelios	697	 63.4%	 1.6%	 46.7%	24.5% (171)
	BCC NPLs 2018	Iccrea Banca	Prelios	1,046	 70.9%	 8.1%	 39.3%	27.0% (479)
	2Worlds	Banco Desio	Cerved	1,002	 71.6%	 5.2%	 44.4%	28.8% (289)
	4Mori Sardegna	Banco di Sardegna	Prelios	1,045	 56.1%	 87.2%	 51.3%	22.2% (232)
	Red Sea	Banco BPM	Prelios	5,113	 71.6%	 11.5%	 54.8%	32.4% (1,657)

Source: KPMG elaborations on public reports issued by Rating Agencies

List of completed GACS with key features (2/2)

Chart 20 - Overview of the completed transactions

	Operation	Originator	Servicer	GBV (€ m)	Secured (% GBV)	OMV South (%)	OMV Resi (%)	Senior Note (% GBV, € m)
2018	Aragorn NPL 2018	Creval	Credito Fondiario	1,671	 75.4%	 23.1%	 43.4%	30.5% (510)
	Siena NPL 2018	MPS	Juliet, Italfondiario, Credito Fondiario, Prelios	23,939	 57.8%	 28.1%	 28.2%	12.2% (2,921)
	FINO 1	UniCredit	doBank	5,376	 52.0%	 34.6%	 49.0%	12.1% (650)
	Bari NPL 2017	BP Bari	Prelios	320	 56.1%	 67.6%	 43.0%	25.3% (81)
2017	Elrond NPL	Creval	Finint	1,422	 73.5%	 23.8%	 32.6%	32.6% (464)
	Brisca	Banca Carige	Prelios	938	 77.2%	 9.2%	 60.3%	28.5% (267)
2016	Bari NPL 2016	BP Bari	Prelios	480	 63.4%	 65.9%	 51.8%	26.4% (127)
Total				62,085	 58.5%	 31.5%	 43.7%	23.8% (11,770)

Source: KPMG elaborations on public reports issued by Rating Agencies

Contacts

KPMG in Italy Portfolio Solutions Group

Domenico Torini

EMA Co-Head Global
Portfolio Solutions Group

Partner, KPMG Italy

Tel: (+39) 3483059270

dtorini@kpmg.it

Dario Maria Spoto

Portfolio Solutions Group

Director, KPMG Italy

Tel: (+39) 3665871464

dspoto@kpmg.it

Simone Colantuoni

Portfolio Solutions Group

Manager, KPMG Italy

Tel: (+39) 3483916527

scolantuoni@kpmg.it

Andrea Boellis

Portfolio Solutions Group

Manager, KPMG Italy

Tel: (+39) 3403729949

aboellis@kpmg.it

kpmg.com/it

kpmg.com/app



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