

Government proposal could inflict significant collateral damage on Italian NPL market



Italian government proposal AC 843, aimed at supporting borrowers in financial difficulty by giving them the option to buy back exposures already sold to third parties through ABS or loan disposals, has created significant turbulence in the NPL market.

The knock-on effects of the proposal's retroactive nature could cause significant damage to the underlying NPL market, although we expect it would have limited impact on the performance of Italian NPL securitisations.

The proposal targets private and SME borrowers whose debts were transferred to third parties through securitisations or loan disposals by 31 December 2022. Borrowers with maximum debts of EUR 25m classified as impaired between 2018 and 2021 will have the option to buy back their loans.

The repurchase price of individual loans will be set by reference to the aggregate sales price of the original portfolio to which the loan belongs plus a premium: 20% if no recovery proceedings have been initiated or 40% for borrowers that have extra-judicial agreements with servicers or those engaged in legal proceedings.

Taking up the buyback option will allow borrowers to clean up their credit status at the Central Credit Register (Centrale Rischi) and give them access to new financings. The aim of the proposal is to promote sustained, inclusive and sustainable economic growth.

No immediate impact on banks' credit quality. While negative at the margin, the proposal would not change the credit profile of Italian banks in the near term. Italian banks no longer carry a large stock of NPLs on their balance sheets so a weaker NPL market would not do any immediate harm.

Since 2015, Italian banks have offloaded more than EUR 290bn in NPLs through recoveries, write-offs and disposals. NPL sales have been a very effective tool for banks to achieve risk deleveraging and risk diversification and to free up reserves to continue lending. In some cases, gross NPL ratios are now as low as 2%. The proposal would impair banks' ability to dispose of NPLs, adding downside risk to asset quality.

The retroactive nature of the proposal has created uncertainty and concern among market participants and investors. Appetite for Italian NPL transactions is likely to plummet as legal uncertainty is priced in. The price that investors will be prepared to bid for notes will fall.

We anticipate delays in transaction cash flows until the proposal is passed or rejected. Legal uncertainty is weighing on the performance of existing NPL transactions. While the proposal is under discussion, borrowers are likely to adopt a wait-and-see approach before reaching extra-judicial agreements with servicers, resulting in delayed NPL collections.

Determining purchase prices is open to interpretation. But it can be inferred that the borrower will pay the average of the portfolio price to which the loan belongs as a percentage of gross book value (GBV) plus a premium. This definition will benefit some borrowers but penalise others, independent of their capacity to pay the option price.

For example, the price to buy back exposures with high expected recoveries or those that are well collateralised would be reduced by the price of unsecured loans, which contribute to the average portfolio price. In this case, the resulting option price would be lower than the expected recoveries contained in servicers' business plans.

The buy-back option would be between 24% and 42% of GBV, considering that mixed portfolios have been sold at between 20% and 30%. Servicers generally forecast average recoveries of 30%-60% for loans with high recovery rates or secured loans. Therefore, there is the risk of decreased portfolio lifetime recovery rates.

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Operational complexity. We believe that a relatively a small share of borrowers will exercise the option because it will be very difficult to implement. Under the proposal, debtors will have 30 days following notification from the issuer to exercise the repurchase option and a maximum of 90 days to pay.

During that period, borrowers will need to understand legal terms, decide whether it is economically worthwhile to exercise the option and determine how to fund the purchase. To be able to exercise the buy-back option, borrowers may look for refinancings from specialised market operators at high interest rates.

Litigation risk. The notification process may trigger litigation by debtors regarding the content and formalities of the notification, which will lengthen resolution timing.



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