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The Italian NPL market

1H 2013 - Market update

October 2013

Index

1 At a glance

The NPL volume and coverage levels

The Gross NPL volume continues to grow and reached €140 bn in July 13. Despite 2012 YE and 1H 2013 have been affected by significant loan loss provisions, the NPL coverage ratio remained pretty flat over the last year.

We believe that next year results will be affected by substantial loan loss provisions in banks' balance sheets with an improvement in the NPL coverage ratio. The substantial increase will be in fact driven by the recommendations of more strict provisioning policies asked by the Regulator. The bottom line impact of such new provisions could be potentially softened in case the draft of 2014 Stability Law on tax deductions on loan loss provisions and write offs will pass.

Focusing on Top Italian Banks, a peer analysis highlights material differences in NPL ratios and coverage: the NPL coverage ratio diverges significantly from bank to bank (from 38% to 61%) as well as the Net NPL ratio (from 0.7% to 9.6%).

Market recent activity and trends

In 1H 2013 investors focused mainly on unsecured assets and platforms. Agos Ducato and Findomestic sold their consumer credit NPL portfolios to two international investors while Delta Group consumer credit servicing platform was sold to Jupiter Group. No material transactions occurred on secured NPLs portfolio, nor on unsecured banking NPL portfolios.

Market outlook

Few portfolio transactions - both secured and unsecured - are currently in the pipeline and 2-3 transactions might close by year end.
Pressure on provisioning levels by the Regulator combined with an expected more favourable tax regime and increasing levels of liquidity in the market is expected to drive sizeable NPL disposals from FY14 onwards.

We expect some transactions will involve not only assets but also platforms: the Spanish market set a new trend in this direction and international investors are showing increasing interest in partnership-like approach on servicing also for the Italian market.

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Size and features of the Italian NPL market

"The Gross NPL volume continues to increase and reached €140 bn in July 2013. Despite Banks' effort in improving the NPL provisioning levels in 2012 YE and 1H 2013 results, the coverage levels remained pretty flat over the last year. For the next year, we expect that the Bank of Italy and European Central Bank focus in banks' asset quality will drive Italian Banks to increase their coverage ratio"

As of July 13, the Gross NPL stock in Italy reached €139.8 bn (+22.3% yoy), recording a significant further annual increase. Since 2008, the Gross NPL grew, on average, at a pace of +31% annually.(**Chart 1**)

As of July 13, the Gross NPL ratio was 7.2% (5.7% in July 12). Considering the breakdown per customer segment, the ratio reached 12.9% for SME, 11.3% for large corporate and 6.0% for retail customers.

Following the NPL increase, Italian banks - with a slight delay - started to improve their NPL coverage levels by more than 10% (on average), though remaining below the pre-crisis levels (**Chart 2**).

Such increases are also linked to Bank of Italy inspections focused on the asset quality that the Regulator carried out in Q4 2012 and 1H 2013 on Top Italian Banks.

Following to such inspections the Regulator asked each bank to adequate their loan loss provisions, implementing more strict policies on provisions, which effects have only been partially seen in 2012 FY and 1H 2013. In the next year, we expect a further substantial impact on YE results.

Such impact could be softened in case the draft of 2014 Stability Law on tax deductions on loan loss provisions and write offs will pass. The new rule would allow the tax deductibility of NPLs provisions in 5 years for IRAP purposes (previously not deductible) with a net profit in the P&L, and for IRES purposes (previously deductible up to the 0,3% of loans booked and the exceeding amount during the following 18 years), with a financial benefit. Moreover, in case of disposal of the impaired assets to third parties the emerging loss could be fully deducted in the year of the disposal for IRAP and IRES purposes.

Chart 1: Trend of Gross NPL stock in Italy

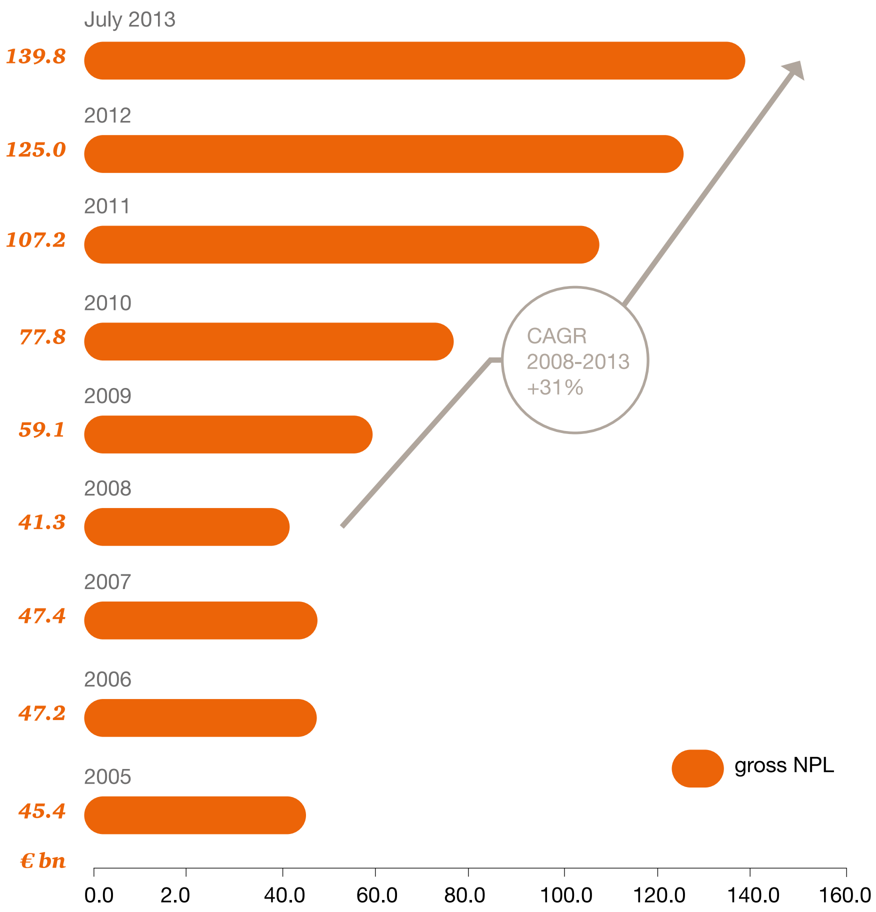
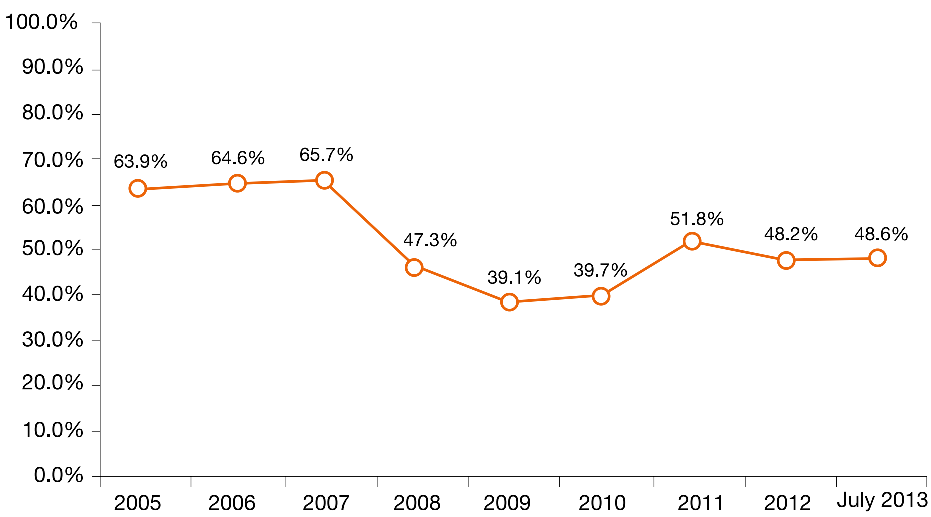


Chart 2: Trend of NPL coverage ratio in Italy



Source: PwC analysis on ABI Monthly Outlook data, September 2013

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Top 20 banks NPL peer analysis

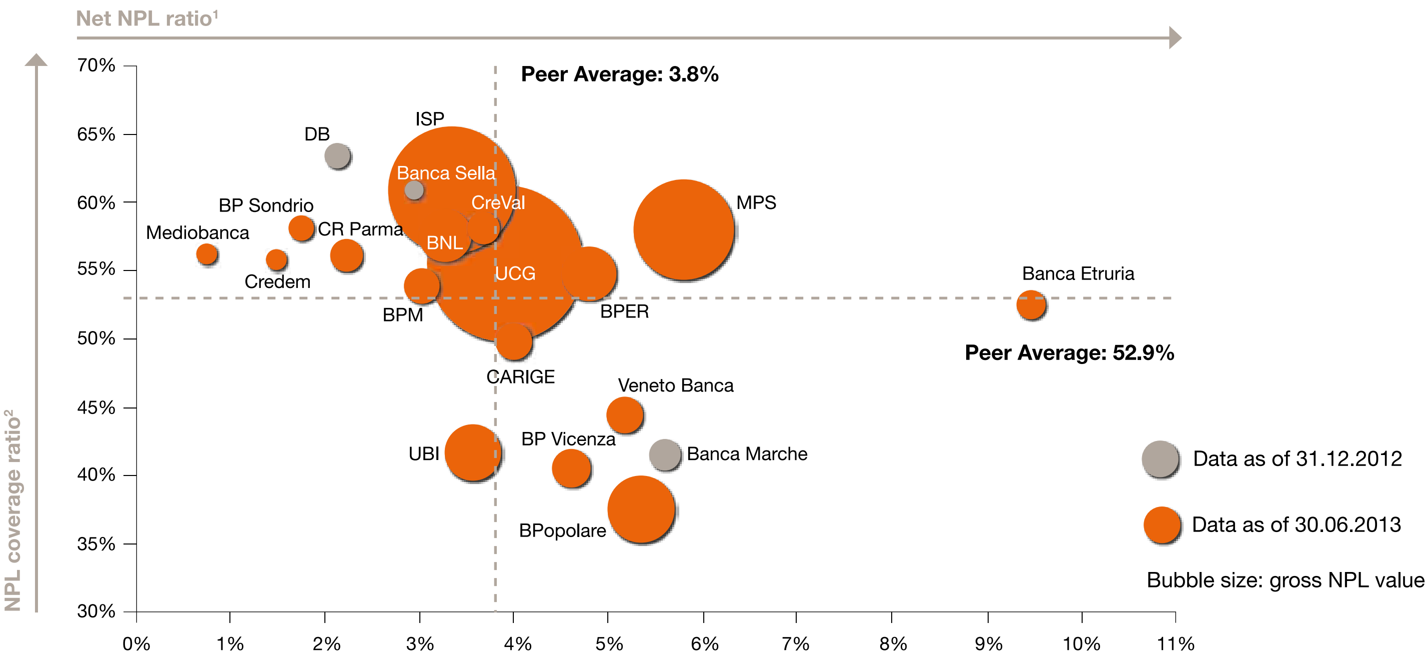
"Focusing on Top 20 banks, there is a significant dispersion around the Net NPL ratio and the NPL coverage ratio. The different positioning around these 2 ratios highlights banks who are more willing to sell and the ones who are more able to sell"

Despite Chart 3 does not consider the different mix of NPL portfolios of Top 20 banks (secured vs unsecured, corporate vs retail, write off policies, etc), the chart highlights a different positioning of the banks in terms of Net NPL ratio and NPL coverage ratio.

In fact, while the Net NPL average ratio is equal to 3.8%, the ratio varies from a minimum of 0.7% to a maximum of 9.6%. In terms of NPL coverage ratio the ratio varies from 37.5% to 63.6%.
Following the different positioning, the willingness and ability to sell diverge among the Top 20 banks.

While banks on the right side of the chart are the ones who might be more willing to sell because of their higher Net NPL ratio; banks with high NPL coverage ratio are the ones better positioned to close a deal on their NPL portfolios because of their higher provisional levels.

Chart 3: Top 20 banks NPL peer analysis 2013



1. The Net NPL ratio refers to the ratio of NPL (net of provision) to total customer loans

2. The Net coverage ratio refers to the ratio of total provisions to total Groos NPLs

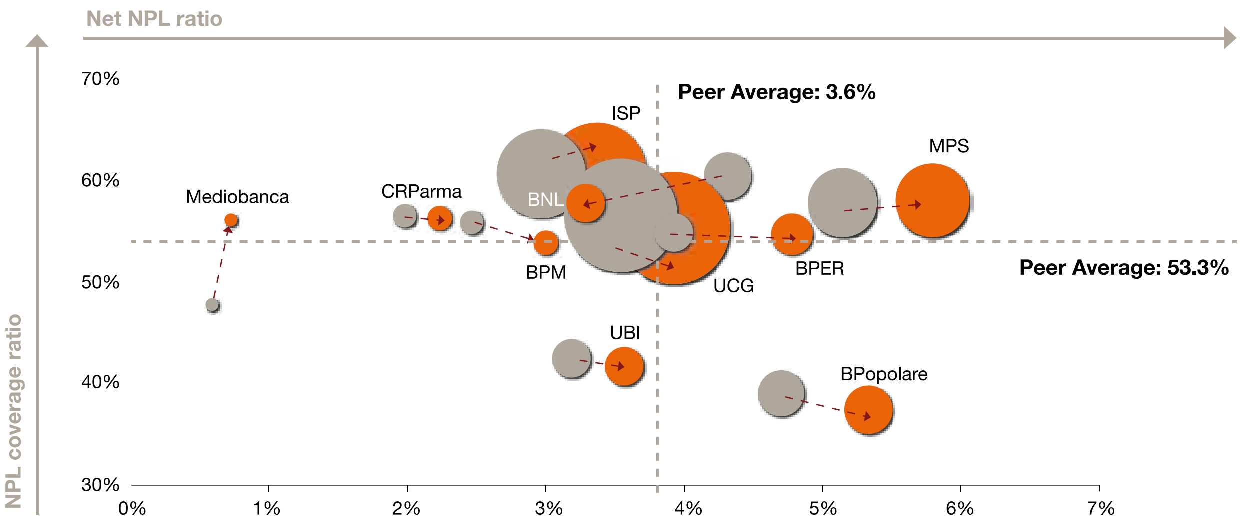
Source: Italian banks 1H 2013 and 2012 FY Balance Sheets

Top 10 banks movements

Overall, 1H 2013 results show an increase in the Net NPL ratio (from an average of 3.3% in 2012 to an average of 3.6%) for all banks with the exception of BNL, for which the values decreased following an intercompany transaction.

NPL coverage ratio remains substantially unchanged from 2012 YE value for all the panel banks, with the exception of Mediobanca whose coverage ratio increased in 1H 2013 from 47.8% to 56.3%

Chart 4: Top 10 banks movements - 1H 2013 vs FY 2012

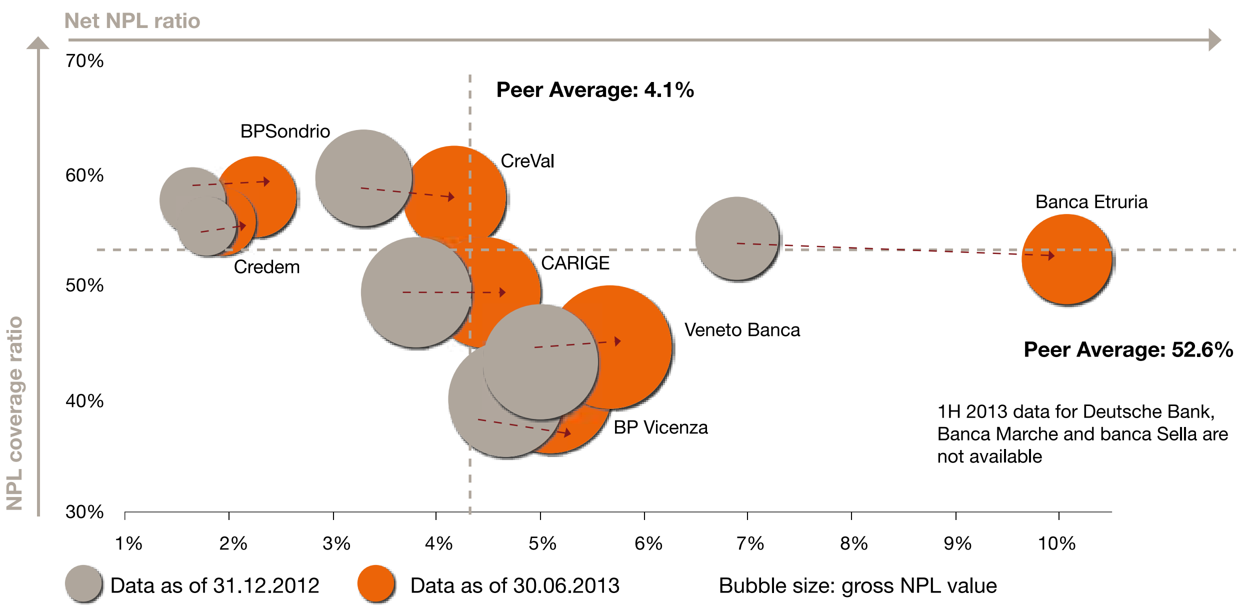


Other Top 20 banks movements

Overall, in 1H 2013 all remaining Top 20 Banks show an increase in the average Net NPL ratio (from an average of 3.4% in 2012 to an average of 4.1% in 1H 2013), with a significant move of Banca Etruria.

The average NPL coverage ratio (52.6%), instead, remains substantially unchanged from 2012 YE value.

Chart 5: Other Top 20 banks movements - 1H 2013 vs FY 2012



Source: Italian banks 1H 2013 and 2012 FY Balance Sheets

Market recent activity and outlook

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1H 2013 activity and trends

As per 2012 trend, in 1H 2013 investors focused on unsecured consumer credit assets and platforms:

- *Agos Ducato (Crédit Agricole Group) and Findomestic (BNP Paribas Group) sold their consumer credit NPL portfolios to two international investors,*
- *Jupiter Group - an Italian NPL non captive servicer - bought Delta Group's consumer credit servicing platform (Tarida).*

Moreover, the segment of payroll salary receivables ("CQS") is currently undergoing some changes in the structure of funding of the business: this might represent an opportunity for players interested both in investing in existing stocks/platforms and in funding the new business at different levels of the capital structure.

Despite the increasing level of provisions on secured loans, some gap in expectations between willing sellers and investors persists. We deem that a closer collaboration between the parties in finding a tailor made solution could help in bridging the gap. Accurate selection of sub-portfolios matching the investment criteria, availability to provide vendor financing and openness to discuss partnership-like approach on the servicing might significantly enhance the chances to close a deal.

2H 2013 and 1H 2014 outlook

Few portfolio transactions - both secured and unsecured - are currently in the pipeline and 2-3 transactions might close by year end.

The establishment of the Single Supervisory Mechanism ("SSM") and the ECB "comprehensive assessment" process will require banks to perform a deep review on their portfolio, prepare over the next six months comprehensive data set and increase provisioning levels. Such information can be used by the banks to better define their portfolio strategy and prepare for potential asset disposal processes.

We foresee more sizeable deals to come in FY 14, thanks also to the increasing amount of liquidity in the market, an expected more favourable tax regime and asset diversification.

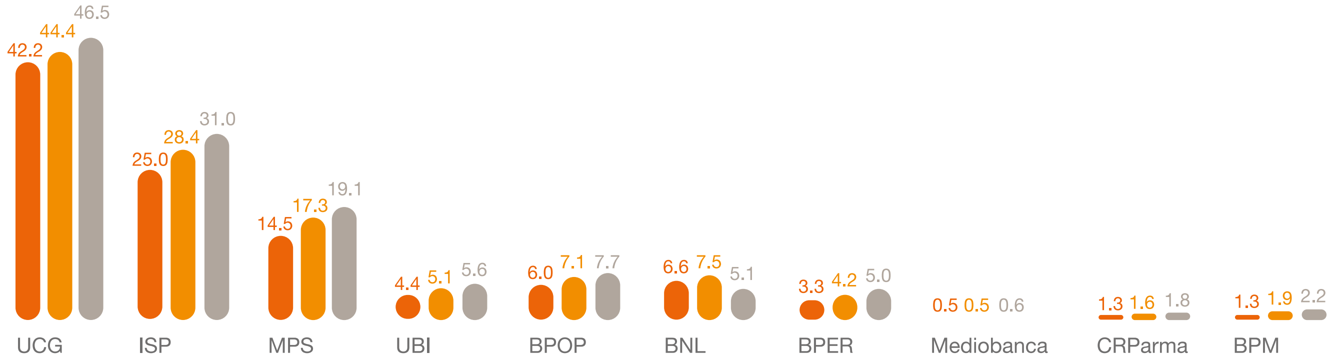
We expect some transactions will involve not only assets but also platforms: the Spanish market set a new trend in this direction and international investors are showing increasing interest in partnership-like approach on servicing also for the Italian market.

The main Italian banking Group, Unicredit, is currently exploring possible partnerships with major funds involving their captive servicer UCCMB.

Appendix - Top 10 banks peer analysis

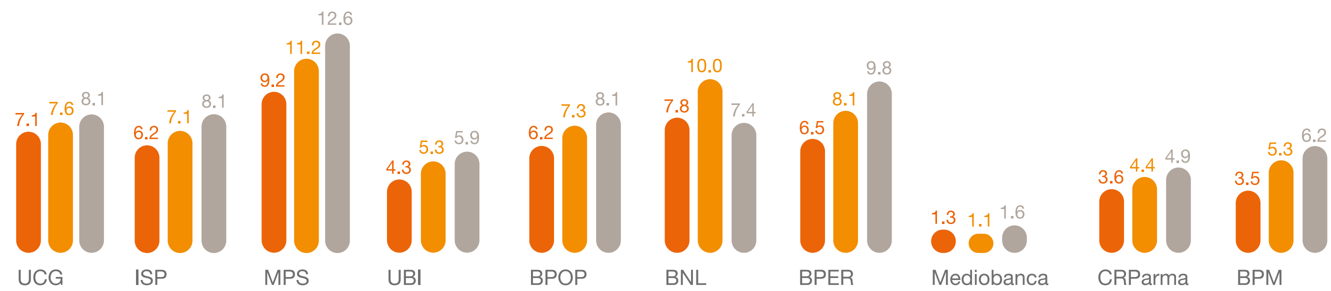
Looking to the Gross NPL stock, it's clear that most of the €140bn is held by the first 3 Italian banks. In terms of trends, the Gross NPL stock continues to increase for all Top 10 Banks with the exception of BNL, who in 1H 2013 did an intercompany transaction, disposing its Corporate NPL to BNP Paribas - Milan Branch.

Chart 6: Gross NPL stock (€ bn)



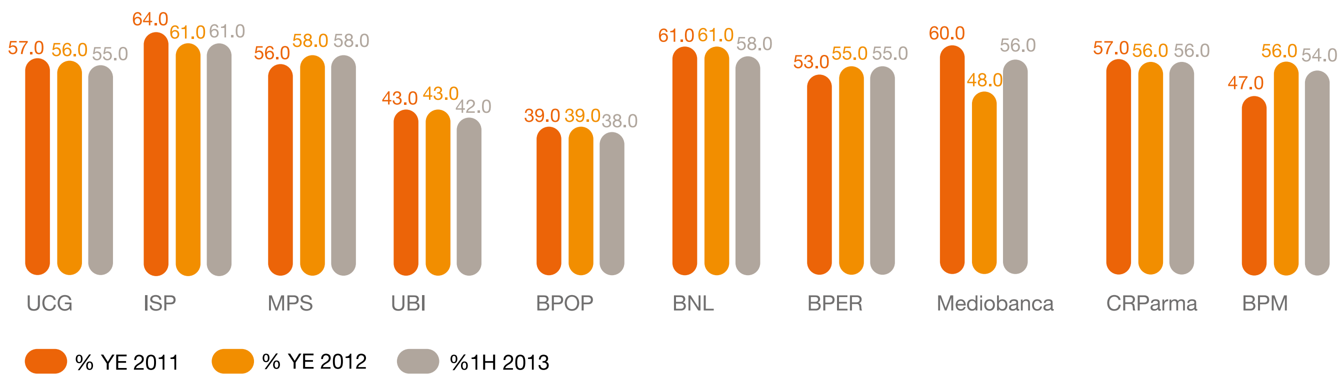
In 1H 2013, as a consequence of the increase in the NPL stock and of the stable/ decrease in customer lending, the Gross NPLs ratio further increased (avg Top 10 banks at 7.3%) for all banks excluding BNL.

Chart 7: Gross NPL ratio (%)



With the exception of UBI and Banco Popolare, in 1H 2013 the Top 10 Banks are pretty aligned in terms of NPL coverage ratio (range from 54% to 61%).

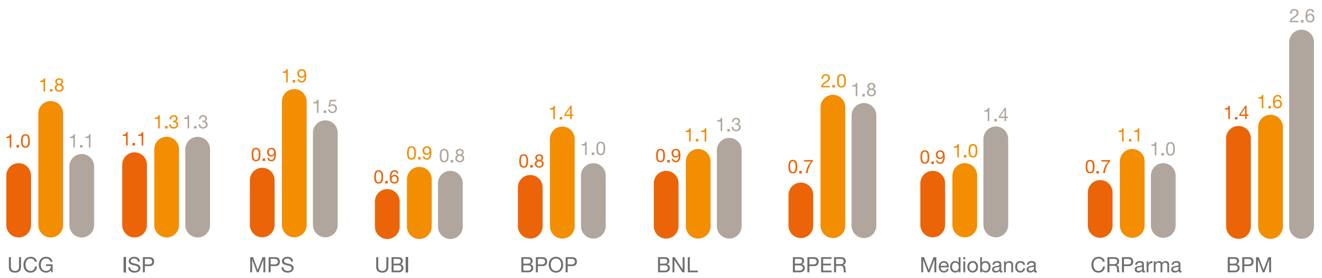
Chart 8: NPL Coverage ratio (%)



Source: Italian banks 1H 2013 , 2012 FY and 2011FY Balance Sheets. For Mediobanca, 1H 2013 data refers to 2013 FY results

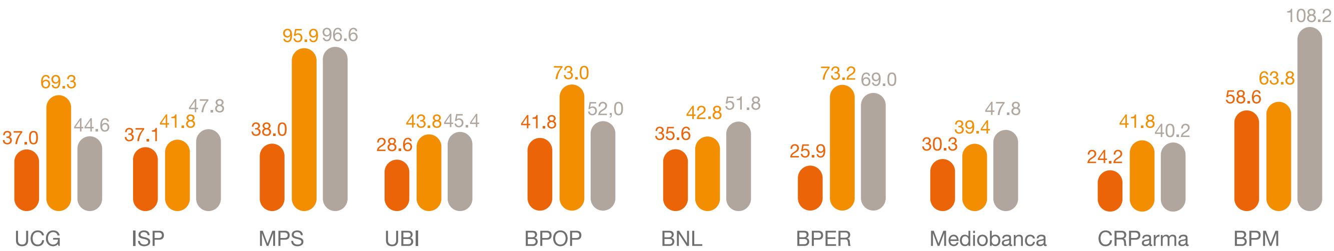
The Top 10 Banks average cost of risk[1] significantly increased in 2012 (from 0.9% to 1.4%). 1H 2013 average cost of risk is the same as per 2012 FY, despite some significant changes occured for some banks (see BPM and UCG).

Chart 9: Cost of risk (%)



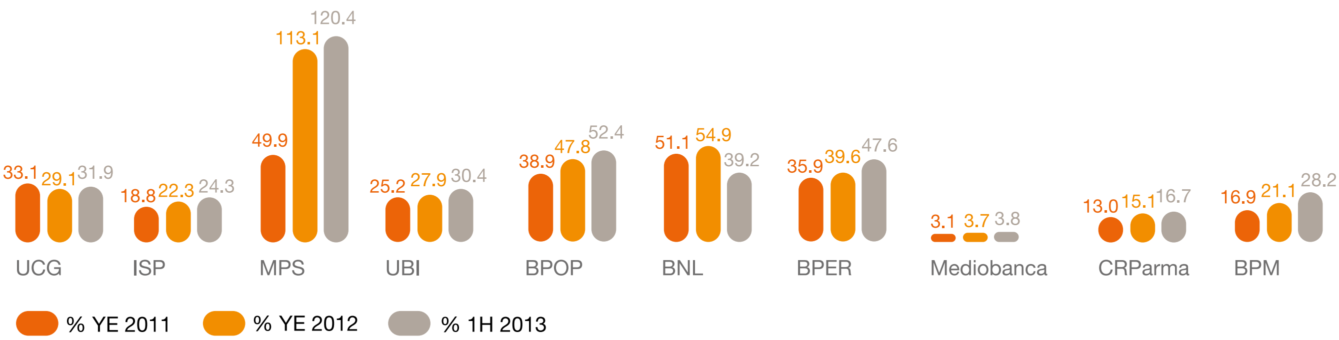
Both 1H 2013 and 2012 FY results show a significant increase in the "Yearly loan loss provisions/ Net interest margin" ratio compared to 2011 results. In particular BPM and MPS have reached the two highest ratio of +108.2% and +96.6% respectively as of June 2013.

Chart 10: Yearly loan loss provisions / Net interest margin



From 2011 to 1H 2013 the total Equity slighltly increased (+5%), while the net NPL value increased by 22%, driving the average net NPL/ Equity ratio to increase by 38%.

Chart 11: Net NPL / Equity



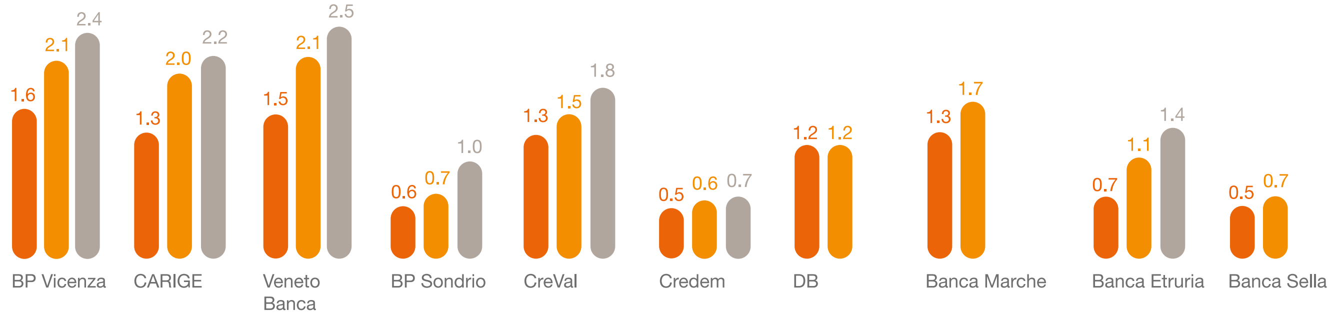
1. Cost of risk: Loan loss provisions / Customer loans. Data have been annualized if required

Source: Italian banks 1H 2013 and 2012 FY Balance Sheets

Appendix - Other Top 20 banks peer analysis

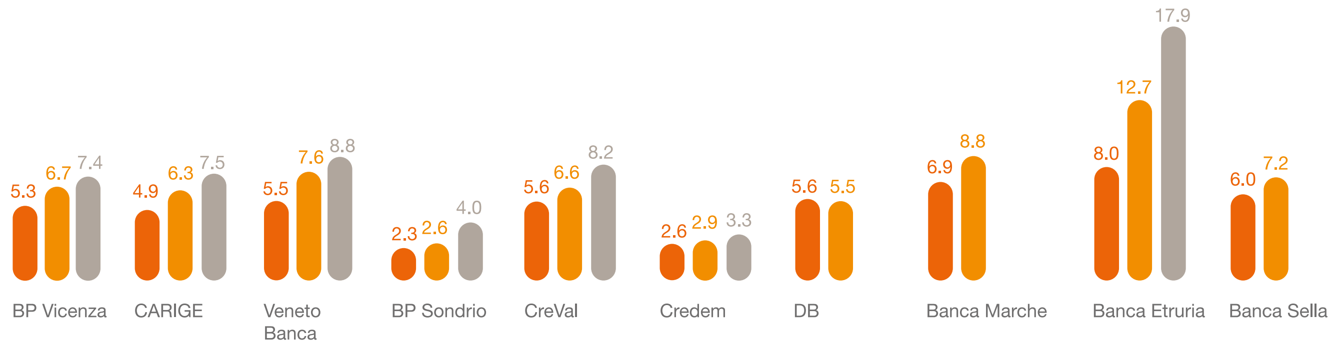
Since 2011, the Gross NPL stock continues to increase for all other Top 20 Banks.

Chart 12: Gross NPL stock (€ bn)



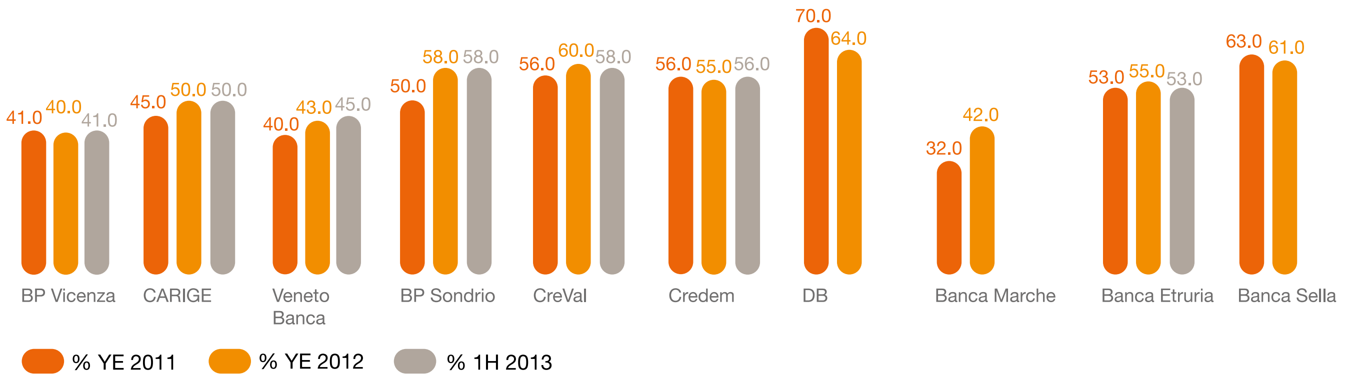
In 1H 2013, as a consequence of the Gross NPL stock increase and of the decrease in customer lending, the Gross NPLs ratio further increased for all the panel banks, moving from an average of 6.7% to 8.2%.

Chart 13: Gross NPL ratio (%)



Focusing on the NPL Coverage ratio, a time comparison shows that each bank in the last 3 years maintains a pretty much stable ratio. Viceversa, a peers comparison shows substantial differences in terms of NPL Coverage ratio among the different banks (from 32-42% of Banca Marche to 70-64% of DB).

Chart 14: NPL Coverage ratio (%)

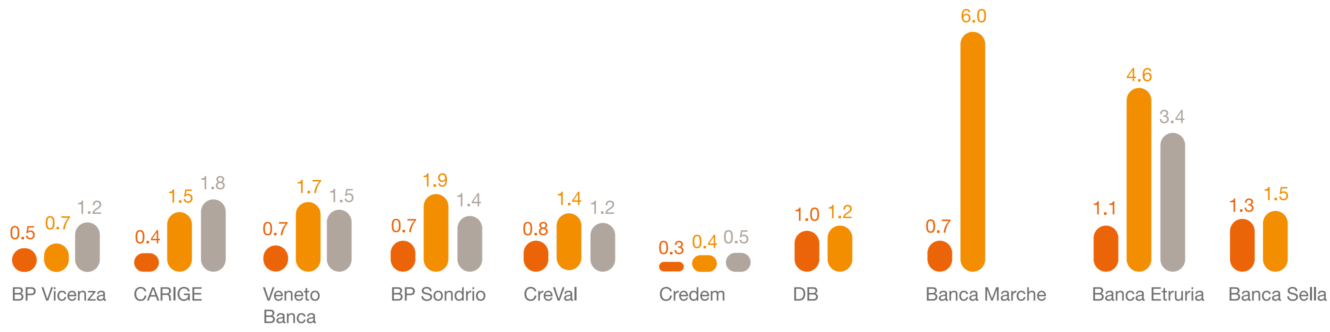


1H 2013 data for Deutsche Bank, Banca Marche and Banca Sella are not available

Source: Italian banks 1H 2013 and 2012 FY Balance Sheets

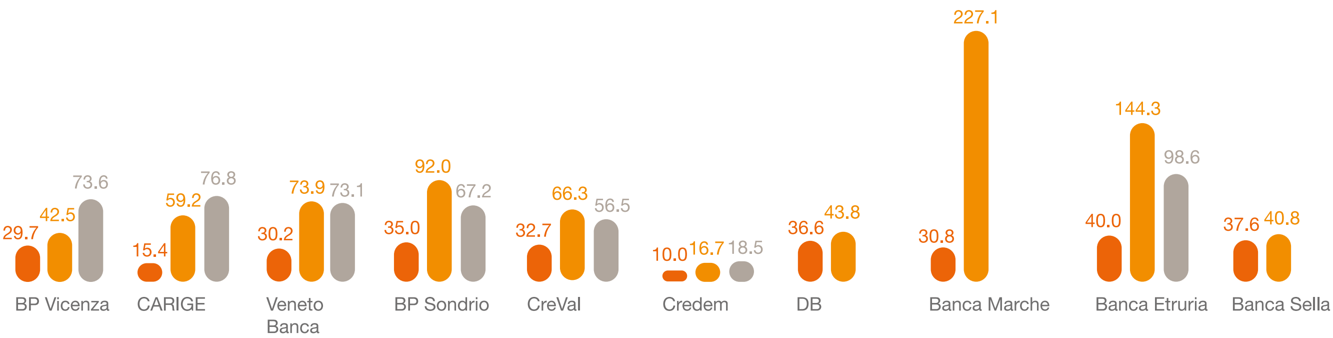
In terms of cost of risk, the panel looks very disomogeneus with Banca Marche and Etruria recording values above 340 bps and Credem below 60 bps. Letting aside these spikes, the average cost of risk in 1H 2013 is around 140 bps, a bit lower compared to 2012 YE results.

Chart 15: Cost of risk (%)



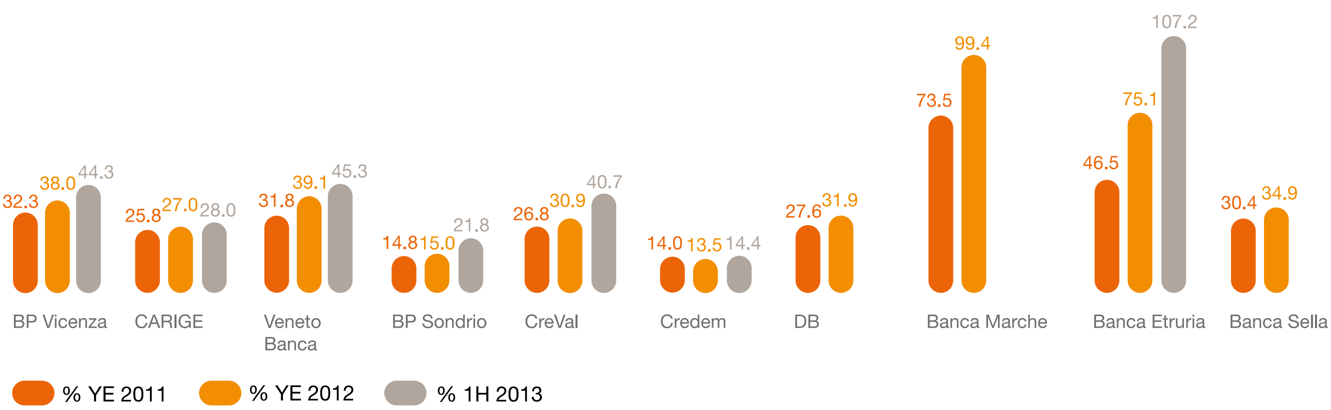
The "Yearly loan loss provisions/ Net interest margin" ratio increased from an average of 30% in 2011 to an average of 66% in 1H 2013. The most significant grow refers to Banca Etruria and Banca Sella.

Chart 16: Yearly loan loss provisions/ Net interest margin (%)



On average, the Net NPL/ Equity ratio has not changed drammatically in the last semester (40% in 2012 vs 43% in 1H 2013). Though, Banca Marche and Banca Etruria clearly highlights their issues.

Chart 17: Net NPL/ Equity (%)



1H 2013 data for Deutsche Bank, Banca Marche and Banca Sella are not available

Source: Italian banks 1H 2013 and 2012 FY Balance Sheets

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