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Italian Non-Performing Loans

How to Structure and Obtain Returns

18 September 2014

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Speakers

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Agenda

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1. Introduction of panel
2. Introduction to the Italian NPL market
3. Market drivers
4. Market participants
5. Structuring a sale
6. Driving a return
7. Q&A

Introduction to the Italian NPL Market

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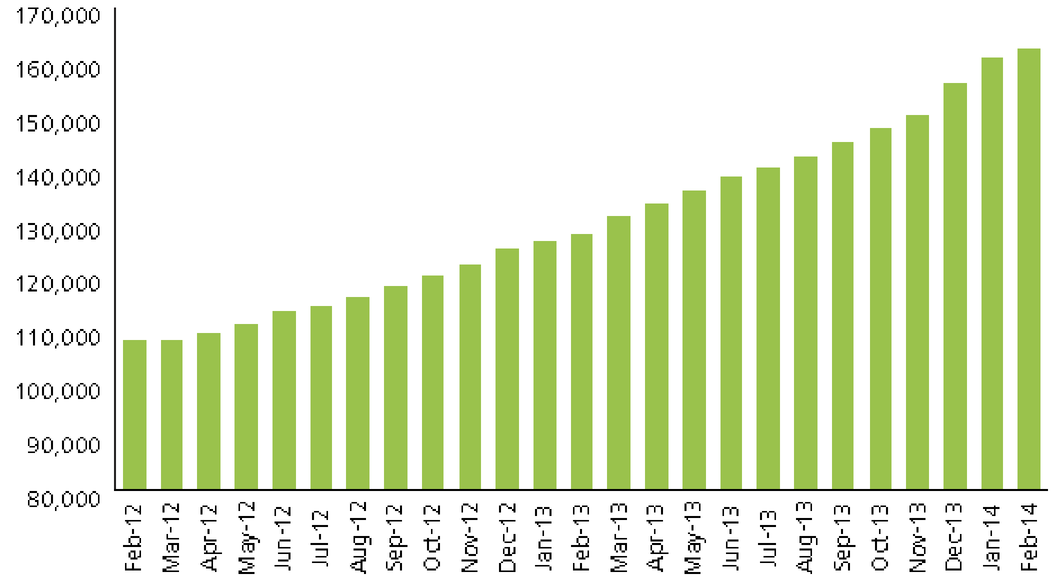
- **Size of Market**
  - The volume of gross NPLs continues to increase and is expected to reach €150 billion by the end of 2014
  - Q1 of 2014 witnessed €23.9 billion of NPL transactions across Europe
  - Q1 of 2014 saw Italian bank NPL transactions (sold or securitised) of over €2 billion (compared with €3 billion for the whole of 2013)
  - Market participants have estimated the sale of approximately €30 billion of NPLs by Italian banks over the next four years (between 1999 and 2008 Italian banks disposed of €60 billion of bad loans)



Source: ABI

Introduction to the Italian NPL Market

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- **Types of Loans**

  - Business Loans
  - Commercial Mortgages
  - Real Estate Loans
  - Personal Loans
  - Purpose Loans

  - Business Loans, Commercial Mortgages and Real Estate Loans are showing the greatest NPL growth

Asset Quality at 31 December 2013 (default rate)

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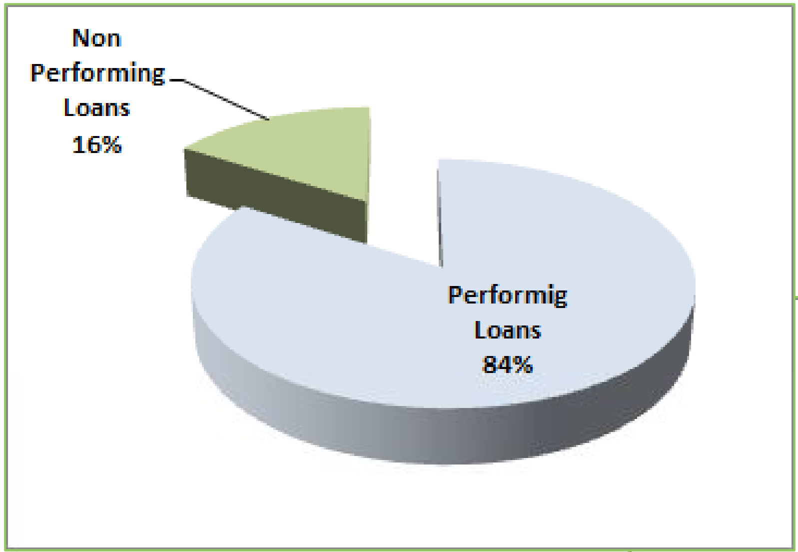

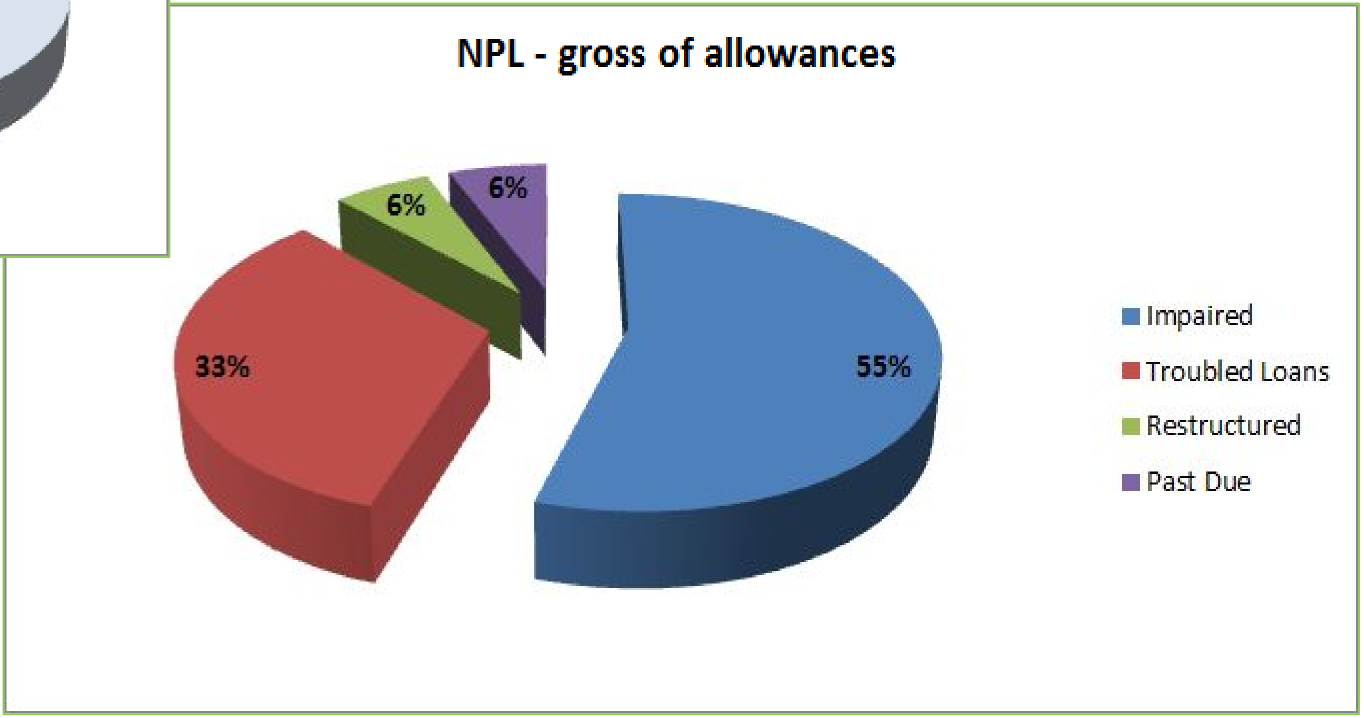

Source: *Bankit Annual Report 2013*

Asset Quality at 31 December 2013

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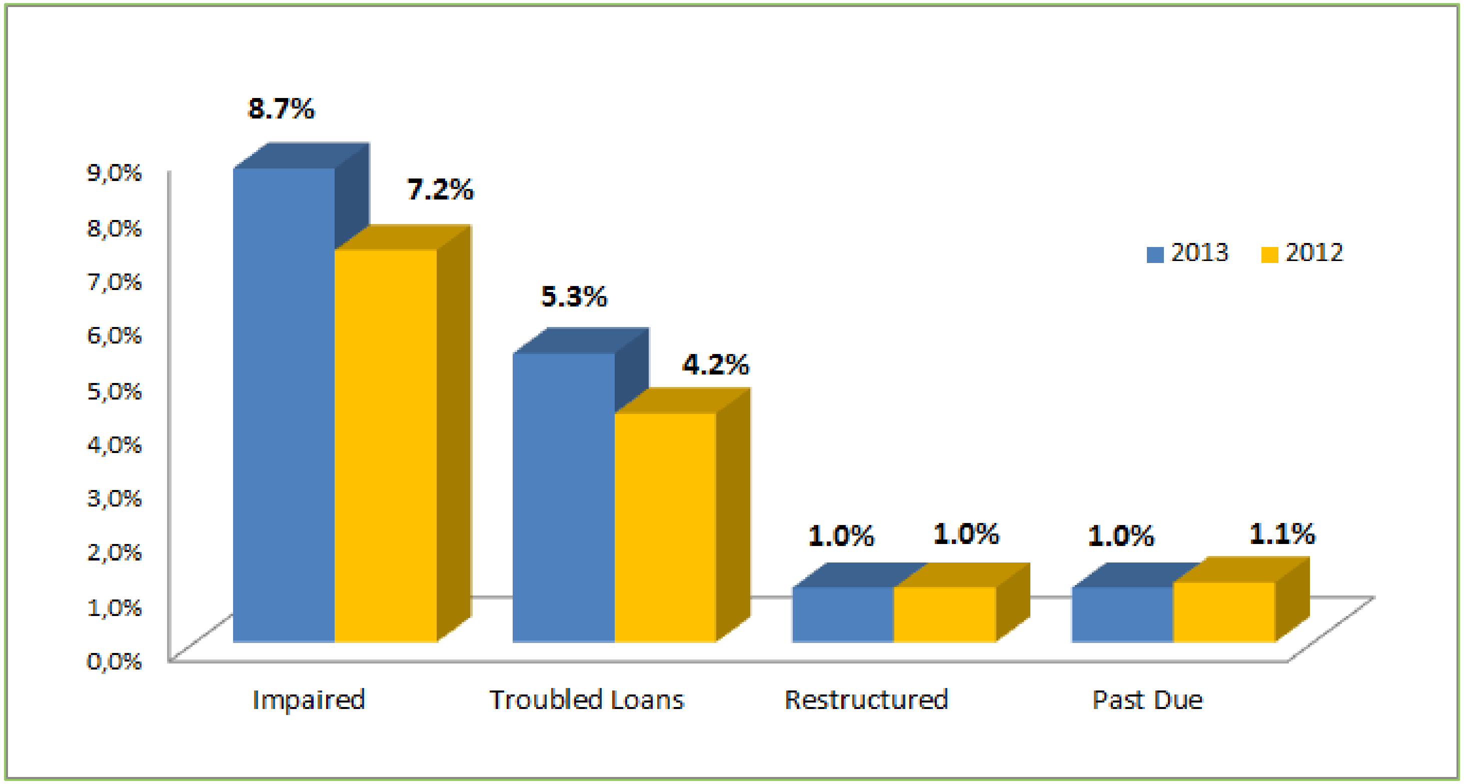
NPL vs Total Loans



"... More than half of NPL had collaterals or personal guarantees (64.4%)... NPLs represent approximately 1/3 of Regulatory Capital (29% at 2012)"

Source: *Bankit Annual Report 2013*

Asset Quality at 31 December 2013

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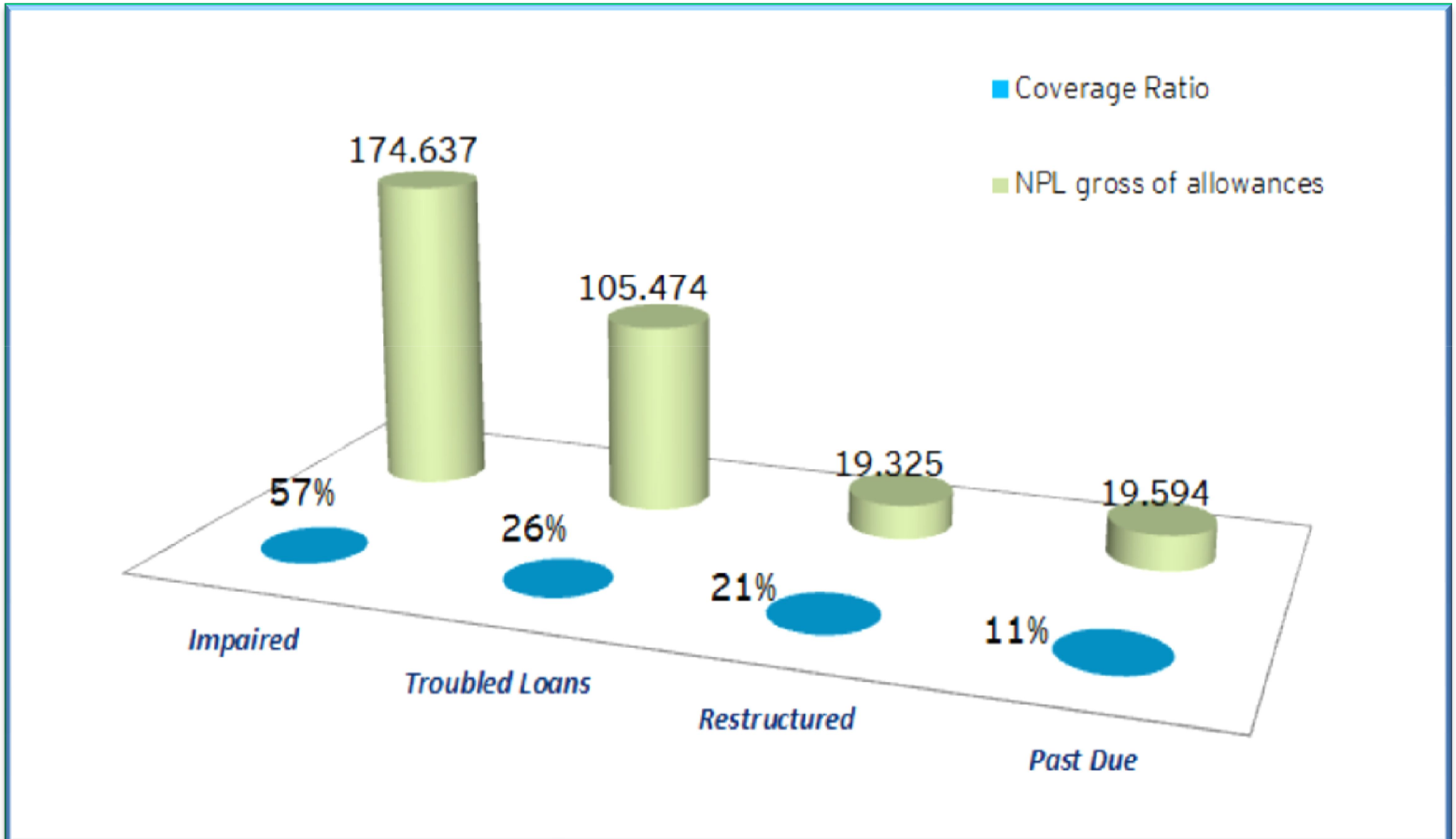
NPL

"... The allowances recorded in 2013 increased by 17.3%"



Source: *Bankit Annual Report 2013*

Total Loans at 31 December 2013

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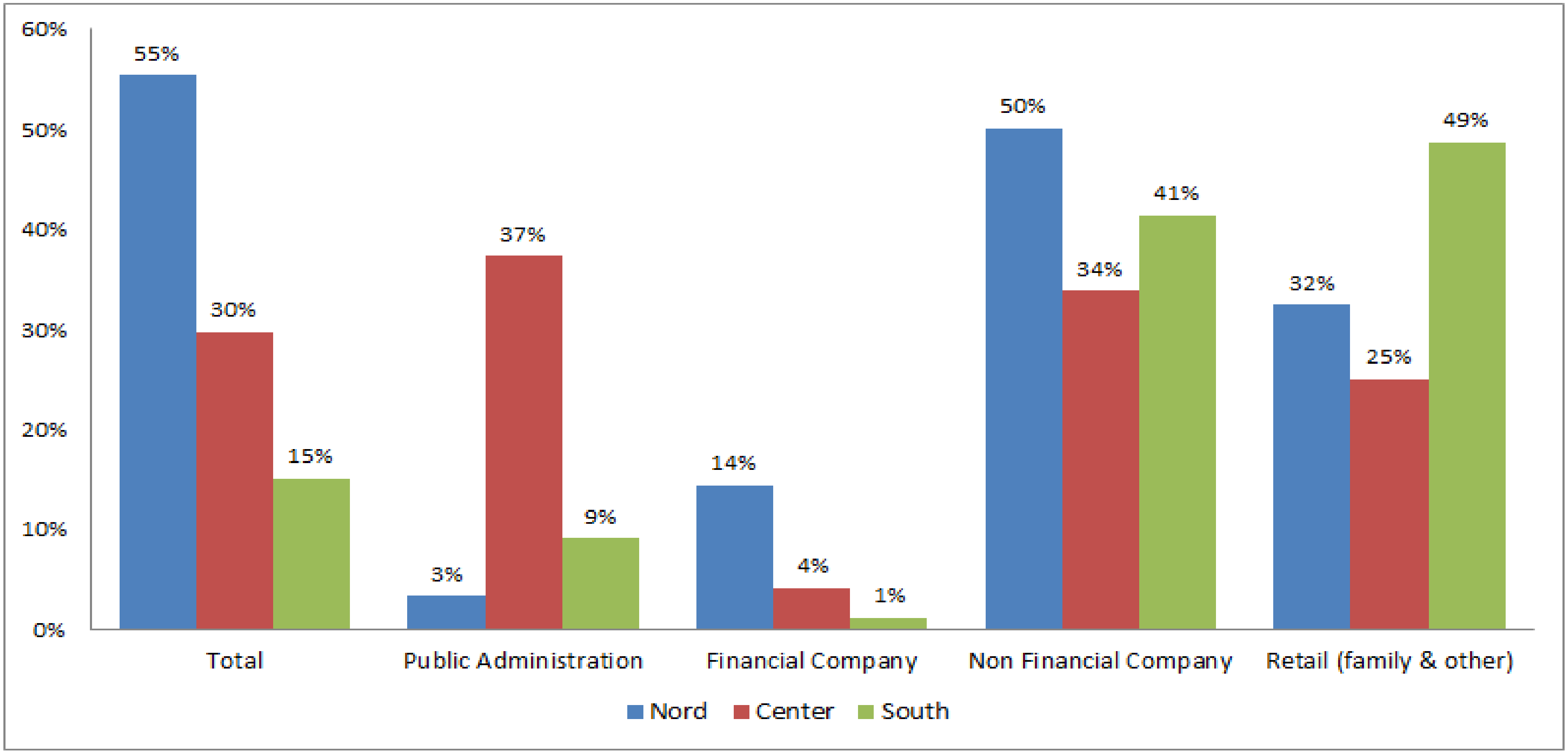
Regional Segmentation

Source: *Bankit statistical bulletin*



Market Drivers

- **"Comprehensive Assessment"**
  - The Comprehensive Assessment includes:
    - an "*asset quality review*" ("**AQR**") carried out by the ECB to enhance the transparency of bank exposure by reviewing the quality of banks' assets, including the adequacy of asset and collateral valuation and related provisions; and
    - a "*stress test*" to be performed in close cooperation with the European Banking Authority ("**EBA**"), which will examine the resilience of banks' balance sheets to stress scenarios
  - Objectives:
    - Transparency – enhance the quality of the information available on the condition of banks
    - Repair – identify and implement any necessary corrective actions
    - Confidence building – assure all stakeholders that banks are fundamentally sound and trustworthy
  - Will be completed before the ECB assumes responsibility for supervision under the Single Supervisory Mechanism in November 2014
  - Covers 131 banks (127 banking groups) across Europe, 15 Italian banks, approximately 85% of bank assets

Market Drivers

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- **Accounting Change:**
  - IFRS9 expected loss model vs incurred loss
  - New classification (forborne exposures – EBA Tech. Standards):

  "Forborne exposures are debt contracts in respect of which forbearance measures have been extended. Forbearance measures consist of concessions towards a debtor facing or about to face difficulties in meeting its financial commitments ("financial difficulties"). A concession refers to either of the following actions:

  > *(a) a modification of the previous terms and conditions of a contract the debtor is considered unable to comply with due to its financial difficulties ("troubled debt") to allow for sufficient debt service ability, that would not have been granted had the debtor not been in financial difficulties;*
  >
  > *(b) a total or partial refinancing of a troubled debt contract, that would not have been granted had the debtor not been in financial difficulties.*
  >
  > *A concession may entail a loss for the lender."*

- **Derecognition: Operational issues for the funds industry**
  - Variability of returns vs risk and reward
  - Relevant activity
- **Tax benefits**
  - The Italian Tax Revenue Agency's tax guidelines published in May 2014 allow larger amounts of loan-loss charges and write-offs to be deducted for tax purposes

Market Participants

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- **Certain institutions have been more active than others**
  - Unicredit accounted for more than €2 billion of NPLs sold in Q1 of 2014
  - Ana Cap bought in excess of €2.7 billion of NPLs between 2013 and Q1 2014

- **Major banks are taking the lead in selling problem assets**

- **Other bidders on transactions have included groups comprising: Fortress, Prelios, Mediobanca, Deutsche Bank, Goldman Sachs, TPG Capital, Cerberus, Jupiter Asset Management, CVC Capital Partners, Blackstone, Oaktree, KKR and Apollo**

Seller	Buyer	Book Value (€'m)	Date
Fiditalia	AnaCap	1,500	2013
Santander	Toscana Finanza	208	2013
Agos	Unknown	500	2013
BCC	Christofferson	150	2013
MPS	AnaCap	551	2013
UniCredit	Cerberus	950	2014
UniCredit	AnaCap	700	2014
UniCredit	Mariner	910	2014
Creval	Ares	36	2014
CR Ravenna	HIG	Unknown	2014
MPS	Fortress	500	2014

Source: *Deloitte NPL Survey 2014-2015*

Market Participants

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- **UniCredit**
  - Reported a net loss of €14 billion in 2013, €12 billion of which were write downs against distressed or non-performing loans
  - Its UCCMB property NPL workout group manages approximately €30 billion of distressed loans
  - UniCredit has indicated it wants to sell another €4 billion of its loans
  - 70% of UniCredit's distressed loan book is real estate lending
  - Values are as low as 10% of face value in some cases

- **Intesa Sanpaolo**
  - €27 billion of bad loans have been placed into its internal "bad bank"
  - The bad bank reportedly holds €46 billion of assets to be reduced by half over the next four years according to the bank's chief executive
  - It is in active discussions with distressed debt investors to dispose of a number of its NPLs
  - It still reportedly has one of the strongest capital ratios of any European bank and is not in any hurry to offload its bad loan portfolios
  - €4.6 billion of annual net loss due to write downs, goodwill and bad loans reported in April 2014
  - The bad bank also includes €1.9 billion of equity stakes in other Italian companies

Market Participants

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- **Banco Popolare**
  - Selling a majority stake in its "Release" workout unit
  - Release manages distressed property loans with a gross value of €3.2 billion

- Fitch reports that progress cleaning up Italian banks' asset quality will remain gradual unless there are more substantial disposals

- Medium sized banks have been less active and will need to take more action to prevent capital shortfalls. Without such action, Fitch believes such banks may fail the upcoming "stress tests"

Market Participants

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- Key transactions
  - Unicredit / Intesa
    - Italy's top two banks
    - Entered transaction with KKR to pool problematic loans into an SPV
    - Loans from both banks have commonality of borrower
    - €1 billion of loans from each lender were placed into the SPV
    - Not removing from balance sheet but pooling makes disposal easier if necessary

Structuring

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- *Main issues to be considered for NPL transfers:*
  - Enforceability of transfer of claims
  - Transfer of guarantees
  - Taxation issues
  - Seller targets (de-recognition and regulatory capital benefits)

- *Typical Italian structures:*
  - <u>Direct transfer of claims to the investors</u> (at present good structure for Italian investors only):
    - Potential tax issue in respect of payment of interest on claims
    - Potential tax issue in respect of transfer of mortgages
    - Potential complexity of enforceability of transfer against assigned debtors

  - <u>Transfer of going concern</u>:
    - Potential complexities linked to transfer of employees
    - Purchaser to be a financial institution with standard capitalisation
    - Purchaser to meet regulatory capital requirements
    - Tax issues in respect of evaluation of the goodwill

Structuring

- <u>Securitisation of NPL claims</u>:
  - Easy procedure for enforceability of transfer
  - No tax issues for payment of interests on claims
  - No tax issues for transfer of mortgages
  - Thin capitalised SPV

- *Main advantages and issues to be faced under securitisation transactions:*
  - <u>Advantages</u>:
    - Segregation of servicer collections
    - Reduced claw back period for transfer of NPLs
    - No claw back risk for payment from assigned debtors
    - Flexible structure (risk tranching, listed/unlisted, rated/unrated, placed/retained)

  - <u>Main issues to be faced</u>:
    - Risk retention regulation,
    - Rating agencies regulation,
    - Obtaining de-recognition and regulatory capital benefits for the seller (risks/benefits, control on SPV/on assets)

Servicer Viewpoint

- Outlook of NPL market for the next 12 / 24 months
- Importance of a Reoco and a real estate strategy in future NPL collection strategies
- Auction Sales: changes in timings and prices in the last 24 months and outlook going forward
- Current bottlenecks in the market

Achieving a Return

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- **Insolvency and Enforcement**
- Insolvency
  - "Insolvency" includes liquidation and restructuring
- Liquidation is likely to be value destructive
  - Process driven by a court appointed trustee and a creditors' committee
  - Sales of assets are carried out through a competitive process
  - Liquidation proceedings last, on average, 4 / 5 years
- Restructuring
  - Will generally lead to higher returns for creditors than a liquidation
  - Key features of a restructuring include: (i) they are all consensual (within court restructuring a majority rule applies: (ii) the restructuring plan is prepared by the debtor and validated by an independent expert; (iii) restructurings grant exemptions from claw back and criminal responsibility
  - Can be used to reschedule debt / business and to convert debt to equity

Achieving a Return

- Be aware of consumer protection issues
  - A claimant cannot apply for bankruptcy adjudication against a consumer
  - Certain assets of consumers can not be subject or only partially subject to enforcement proceedings
  - New law approved in 2012 to allow consumers to apply for restructuring and liquidation proceedings which are similar to proceedings for commercial enterprises
  - Very few consumer proceedings have been initiated meaning recovery statistics are limited

Mortgage Enforcement Procedure

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Step 1

Enforcement Title and Preliminary Notices

- Obtainment of an Enforcement Title
- Notification of the Enforcement Title to the debtor, together with the Order to Pay

Step 2

Attachment

(not earlier than 10 days and no later than 90 days)

- Notification through a court bailiff of the Enforcement Act to the debtor
- Registration of the Enforcement Act in the relevant land register

Step 3

Sale: Request

- The secured creditor requests the forced sale of the mortgaged property to the court where it is located
- Following the request, the court fixes the date of the hearing to discuss any objections

Mortgage Enforcement Procedure

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Step 4
Sale: Court Order

- If no objections are made or an agreement is reached among the parties, the court orders the sale without public auction, and sets a deadline for the deposit of the bids.
- If: (i) no bids or valid bids are made; (ii) bids are made for an amount lower than the minimum price; (iii) public auction appears to be more favorable; or (iv) the sale without auction has not taken place, the court orders the sale by public auction

Step 5
Sale: Public Auction

- No later than 10 days before the first auction, the secured creditor may ask the court to obtain the assignment of the mortgaged property if no bids are made
- The court shall determine the minimum bid price on the basis of an expert's valuation
- The sale auction starts and bids are made pursuant to the applicable rules

Step 6
Assignment

- If no bids are made:

(i) The mortgaged property may be assigned to the secured creditor who asked for the assignment

(ii) A receivership may be appointed for the administration of the mortgaged property; or

(iii) A new public auction may be held (with a reduction of the minimum price)

Mortgage Enforcement Procedure

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Step 7

Further Procedure

- If the minimum price is reduced (see Step 6 (iii)), the court orders the sale without auction (the procedure set out under Step 4 will apply).
- If the minimum price is not reduced (see Step 6 (iii)), the court orders the sale by public auction (the procedure under Step 5 will apply)

Average duration of the procedure: 30 / 36 months (it depends on the courts)

How can the procedure be sped up?

Mortgage Enforcement Procedure

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The court can delegate the sale procedure to outside professionals (for example notaries). The court sets from the beginning the timing and conditions of the sale process that usually are:

- 3 sales (each first without auction and then with auction) with a progressive price decrease of 25% from the price of the previous (attempted) sale (there is always a minimum sale price: at the 3rd sale it will be 42% of the initial starting price);
- usually 1.5 / 2 months run between the sales, i.e. 3 sales are carried out in 1 year;
- if the 3rd sale fails, the professional reports back to the court. Depending on the circumstances the court may order a fourth sale with a further price reduction or stop the process and order a judicial administration (keep in mind that the main concern of the court is to recover the court expenses, i.e. expert's and professional's fees).

Statistics show that the property is typically sold at the 3rd sale.

Any Questions?

Speaker Biographies

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Daniela Andreatta

Restructuring and Insolvency Counsel, Orrick - Milan office

Daniela's practice covers cross-border corporate transactions and the so called "special situations", which include investments in distressed assets (non-performing loans, debt and/or equity in listed/unlisted distressed companies), buy-outs from insolvency proceedings and bankruptcy-related litigation. In the past five years she has been ranked among the key individuals in Chambers and Partners Europe and Global. Sources describe her as "fair, honest and straight to the point." She earns praise for her ability to deal with difficult counterparties. She is also named as a highly recommended lawyer in restructuring and insolvency by Legal 500. Ms. Andreatta is often a lecturer at conferences and she has published several articles on Italian bankruptcy law.

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Emanuela Molinaro

Real Estate Partner, Orrick – Milan office

Emanuela has advised on real estate aspects of a wide range of corporate transactions and has also gained significant experience in the area of real estate transactions and construction law, having assisted domestic and international investors in connection with various property and property-development transactions in Italy, including the disposal of complex real estate portfolios, sale and lease-back transactions, land acquisition and building redevelopment.

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Speaker Biographies

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Gianrico Giannesi

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Gianrico's practice is focused on structured finance, with a particular emphasis on CMBS, RMBS, CBO and securitization of leasing, consumer loans, commercial receivables, public receivables, trade receivables, healthcare receivables and tax receivables. He advises the leading Italian and international banks acting as arrangers, lead managers and originators. Gianrico has been ranked among the key individuals in Chambers and Partners (Europe) in Banking & Finance and in Legal 500 (EMEA) in Debt Capital Markets.

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Stephen Phillips

Co-European Restructuring head, Orrick – London office

Stephen has extensive experience in advising banks, bondholders and corporate groups on restructuring, corporate and banking matters. Chambers UK (2013) notes that Stephen is described by one client as "very savvy from a commercial point of view. He understands what goals we are trying to achieve and finds a legal way to get us there." He is also named as a highly recommended lawyer in corporate restructuring and insolvency by Legal Experts (2011) and regularly speaks at conferences and seminars in the UK and across Europe. He has published several articles in leading business sector titles and is regularly quoted in national and sector press

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