Italian NPLs: indemnities do not fully protect issuers

Lower than expected indemnity proceeds and long indemnity processes have led to recovery shortfalls in most Italian NPL transactions so far.

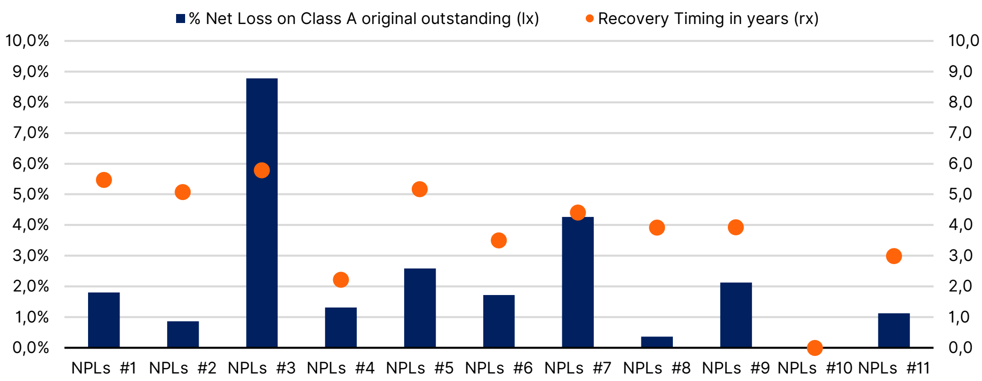
Sellers of Italian non-performing loan securitisations provide representations and warranties (R&W) on the portfolios they dispose of as standard practice. If a breach of R&W materially and adversely affects the workout process of the underlying loans and consequently the issuer's expected recoveries, the seller must contractually indemnify the issuer for any loss.

Indemnities are intended to protect issuers from credit losses, but according to our calculations based on closed indemnity processes[1], indemnity payments do not always ensure full protection hence fully compensate issuers for R&W breaches.

Indemnity processes have also taken longer than expected. For more than 30% of transactions, the process has taken longer than the weighted average life (WAL) in business plans. Delays in indemnity payments are credit-negative. Indemnifiable amounts typically correspond to the purchase price of the loans, which is lower than the expected cash flows in servicers' original business plans. The difference should in principle be covered by shorter collection periods. Longer indemnity processes limit this compensation mechanism.

On a weighted-average basis using data to the end of 2023, issuers received 62.8% of indemnity amounts requested, 4.3 years after closing. On average, issuers experienced a shortfall in terms of net cash flow of 2.3% of the original notional of the Class A notes.

Figure 1: Indeminities: net shortfall and timing for closed processes



Source: NPL servicers, Scope Ratings

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[1] This refers to transactions where the issuer and the seller reach agreement on requested indemnities and no further payments are expected to be received from the seller to cover any shortfall from collections on indemnifiable positions.

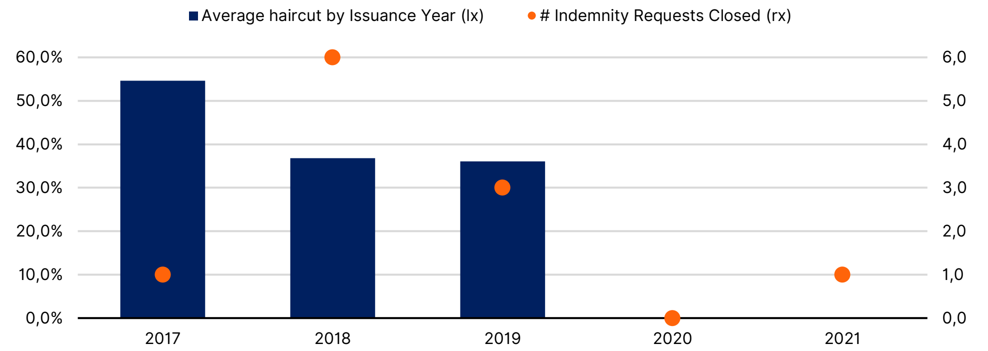
1. Lower than expected recoveries

All transactions rated by Scope have been subject to indemnity requests apart from one with no indemnity request following the expiry of the enforceability period. For some transactions with ongoing indemnity processes, servicers have submitted indemnity requests but these were below the deductible amounts per transaction i.e. their amount was below the minimum threshold for indemnities so might result in zero indemnity proceeds.

On a weighted average basis, issuers received 62.8% of requested indemnities.

To-date, indemnity processes have closed for 11 out of 46 transactions and issuers have received 62.8% of requested indemnities on a weighted average basis, a material haircut.

Figure 1: Average haircut on requested indemnities per year of issuance[2]

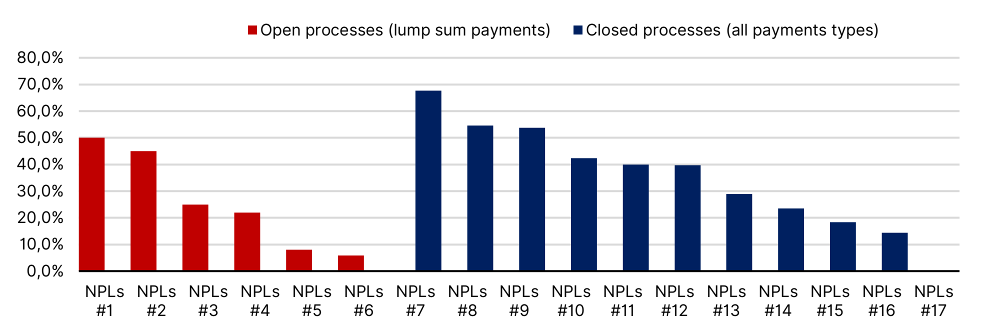


Source: NPL servicers, Scope Ratings

The size of the haircut has varied, depending on negotiations between issuers and sellers (Figure 3). In some instances, this led to lump-sum payments being made, typically covering a lower portion of total indemnities requested.

On closed indemnity processes, where the servicer has agreed on a lump sum payment, the haircut on the total amount requested has varied between 14% and 42%, with payments received within four to 4.5 years of transaction closing dates. This not only evidences a high level of volatility on final indemnity payments but also that having issuers and sellers agree on a lump-sum payment does not necessarily shorten the process. Even on some open processes for which a lump sum payment has been agreed for a portion of the indemnity requested, volatility remains high (Figure 3).

Figure 2: Distribution of indemnity haircuts, including some open processes



Source: NPL servicers, Scope Ratings

[2] For the transaction issued in 2021, no indemnities were requested after expiration of the enforceability period.

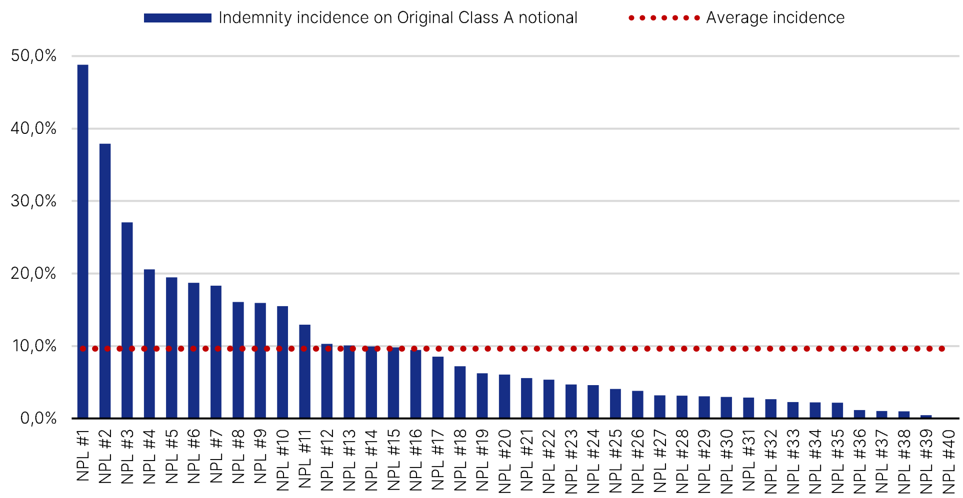
Once the indemnity process is closed, servicers can still focus on loan workouts but if impairment is high, additional recoveries could be marginal. Some transactions have clauses allowing sellers to buy back positions subject to indemnity requests. Therefore, when sellers expect to recover more, they may be inclined to buy positions back and work them out rather than paying indemnities to the servicers.

Requested indemnities for closed processes have on average represented 5.5% of the original notional of senior notes (indemnity incidence), with transactions registering an average net cash flow shortfall[3] equal to 2.3%, although shortfalls have been as high as 8.8% (see Figure 1 on p1). Shortfalls are calculated in line with the purchase prices of the loans. Therefore, the gap would be bigger if measured against the cash flows expected by servicers.

Indemnity incidence[4] for all transactions was 9.6% on average (Figure 4) compared to 5.5% for closed processes only. The indemnity incidence levels varied across transactions mainly based on the quality of portfolios. However, this is also affected by the presence of potential indemnity claims. These are potential breaches of R&Ws that are communicated to sellers within indemnity periods but they may not materialise, thus reducing final indemnity incidence.

The average indemnity incidence is 9.6% of the original senior note notional.

Figure 3: Indemnity incidence on Class A original balance (open and closed processes)



Source: NPL servicers, Scope Ratings

2. Long time to collect

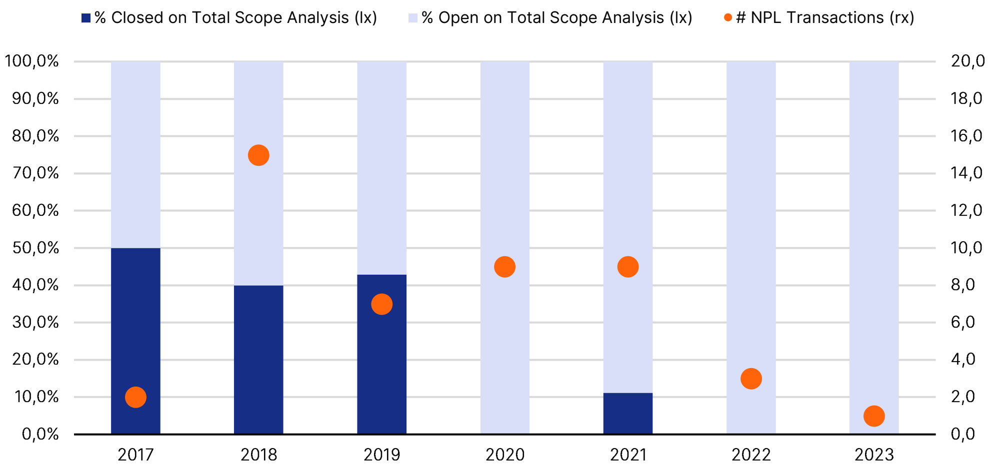
Indemnity processes have been concluded in only 24% of the Italian NPL transactions rated by Scope. Even considering the most seasoned transactions i.e. closed before 2020 (Figure 5) the share of transactions with indemnity processes concluded remains low (30%). None of the indemnity processes have closed for transactions with issue dates beyond December 2019, and more than 60% of transactions closed between 2018 and 2019 still have open indemnity processes. In 2021, one transaction requested no indemnities.

70% of the most seasoned transactions have ongoing indemnity processes.

[3] The average net shortfall is the difference between the indemnity requested by the issuer, in terms of purchase price, and the indemnity received by the seller, divided by the initial notional of the senior note at the issuance date of the transaction. The figure refers only to closed indemnity processes.

[4] Indemnity incidence is the ratio between the total indemnity amount requested by the issuer to the seller and the original senior notes notional (Class A).

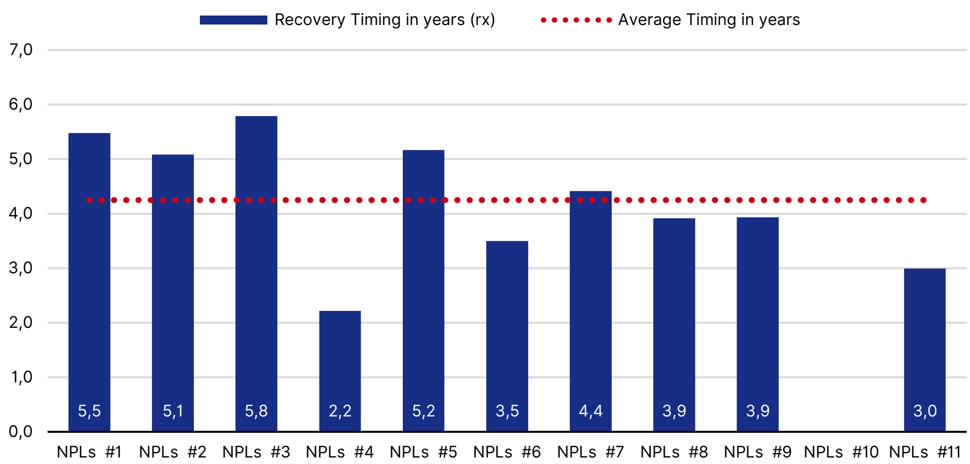
Figure 4: Indemnity process status by issuance year



Source: NPL servicers, Scope Ratings

For transactions with closed indemnity processes, indemnity payments were received by issuers 4.3 years on average after the issue date (Figure 6), slightly longer than the average 4.2-year WAL of original business plans.

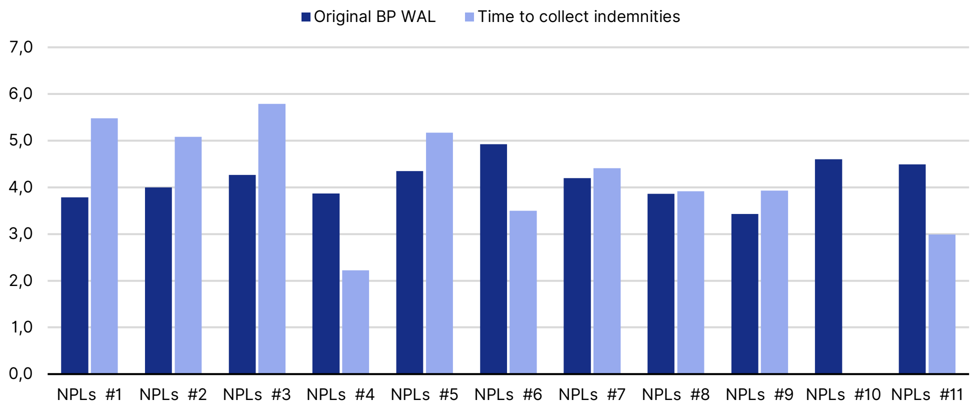
Figure 5: Length of closed indemnity processes



Source: NPL servicers, Scope Ratings

The WAL of a servicer's business plan can be seen as a proxy for the average expected time to collect a portfolio's loan proceeds. Collections from indemnifiable positions may be collected in a different time span depending on each loan. In only three instances out of 11 did issuers collect indemnities earlier than the average expected cash-flow timing of the original business plan (Figure 7).

Figure 6: Length of the closed indemnity processes vs. business plans original WALs



Source: NPL servicers business plan, Scope Ratings

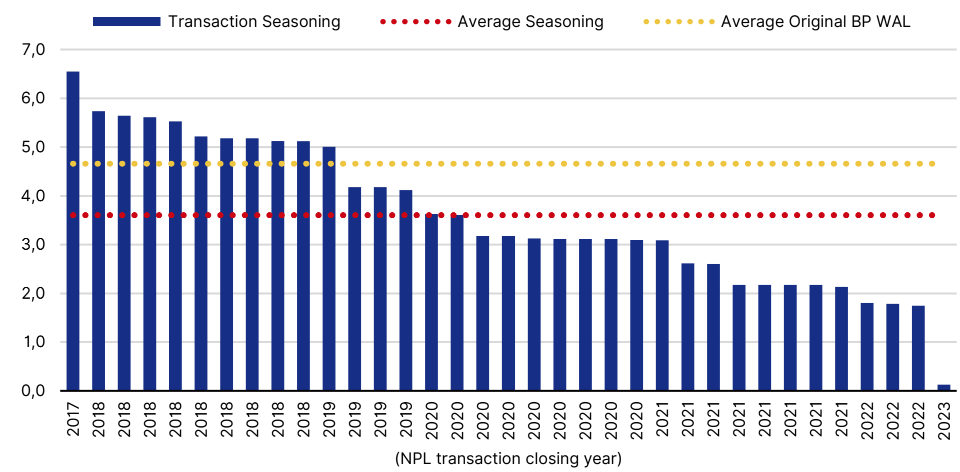
30% of the ongoing indemnity processes has already been outstanding for longer than the respective business plan WAL.

Open indemnity processes have been ongoing for an average of 3.6 years compared to the average WAL of original business plans of 4.7 years (see Figure 8). However, for more than 30% of transactions, the length of the indemnity process is already longer than the WAL business plan.

Sellers do not typically pay indemnities immediately upon issuer request and some may be rejected. There are generally long discussions between sellers and servicers (acting on behalf of issuers) regarding the eligibility and size of indemnities. The transfer agreement generally details the precise steps for indemnity requests but does not define a deadline for payment by the seller.

Some servicers have set up units to streamline indemnity processes, but because discussions between sellers and servicers can last for years, collection delays increase the WAL of cashflows and consequently transaction costs. These costs include negative carry and base fees accruing while positions are under discussion for indemnity claims. Across the universe of Italian NPL transactions rated by Scope, several processes are still open for transactions originated in 2017 and 2019, while the average original business plan WAL was around 4.5 years. Delays on indemnity payments are credit negative for transactions.

Figure 7: Length of open indemnity processes



Source: NPL Servicers, Scope Ratings

Appendix 1 – Indemnity framework overview

R&Ws given by sellers on underlying loans are limited in time and amount, according to certain provisions generally included in the transfer agreement.

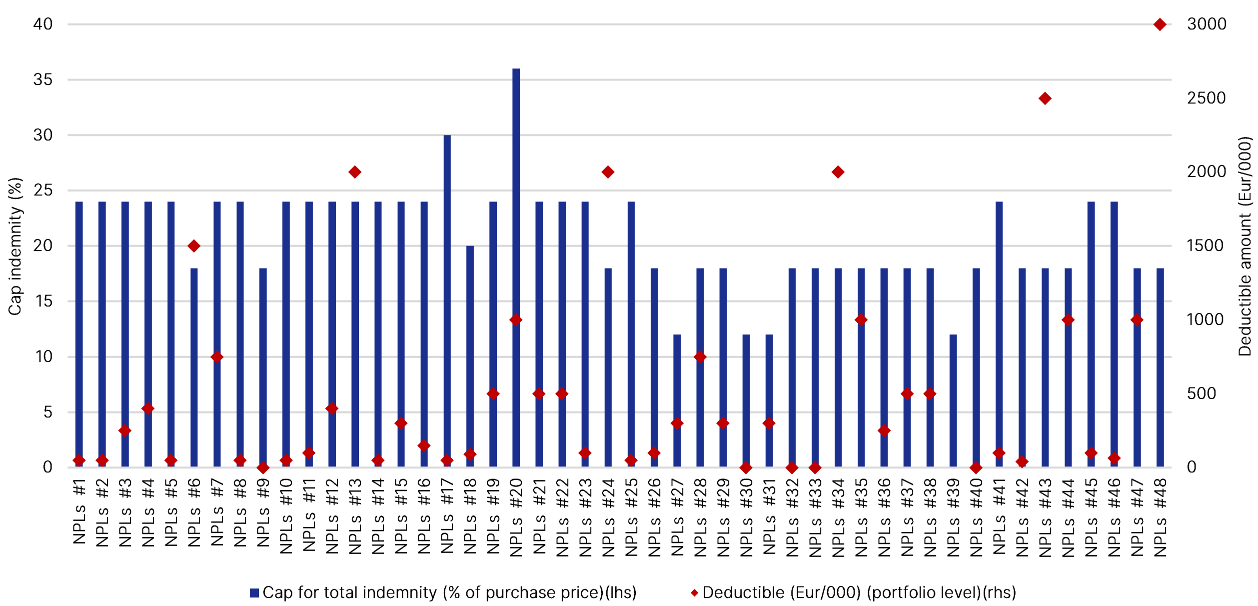
Indemnity period. R&Ws are enforceable by the issuer only within a period that generally spans 12 to 36 months from the transaction's closing date (the "enforceability period"), on average 21 months.

Indemnity computation. Indemnity requests are based on the purchase price rather than the expected cash flows estimated by servicers in their business plans. The issuer typically has the right to receive indemnities up to the purchase price of the loans i.e. up to the price paid by the issuer itself to the seller(s) at the closing date of the transaction. However, the purchase price is generally lower than servicer's original business plan cash flow expectations, as it is determined by discounting the initial net cash flows in the business plan associated with the loans. Additionally, different portfolios may have different discount rates, since the calculations are conducted at portfolio level rather than single positions.

Indemnity limits. The total amount of indemnities payable to the issuer is typically capped at a certain share of the portfolio's purchase price (the "cap"), and is subject to specific deductibles, on average 23% and EUR 850,000.

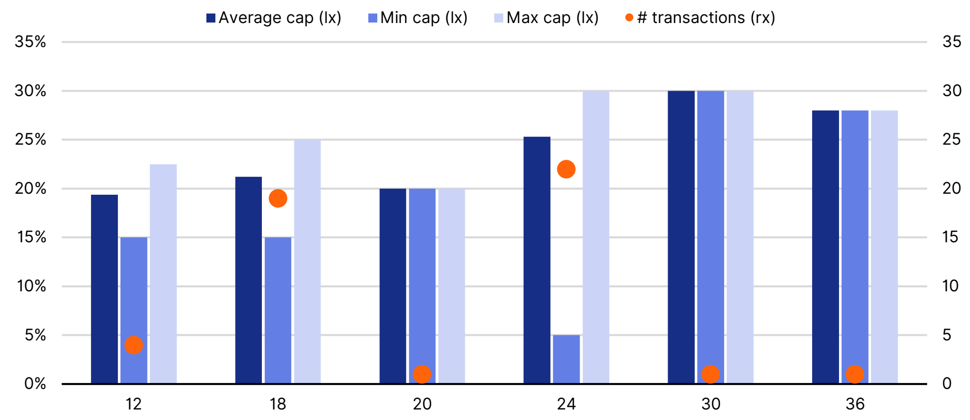
In the context of Italian NPL securitisations, the treatment of indemnities has evolved through time, partially due to the learning experience of servicers and sellers. Deductible amounts at portfolio level show material variability as they are typically based on the size of the securitised portfolios along with other commercial arrangements and market practices. However, these amounts are typically negligible relative to total transaction cash flows. It is worth noting that a few transactions have envisaged different deductible amounts, one for the portion of the portfolio analysed through the servicer's due diligence and one for the remainder, with the former being higher than the latter.

Figure 8: Indemnity caps and deductible amounts per transaction



Source: Transaction Documents, Scope Ratings

Figure 9: Indemnities cap split by R&W duration*



*Min, max and average cap are shown as percentage of the portfolio's purchase prices.
Source: Transactions documents, Scope Ratings

"Contractual clauses" may limit the "validity" of the R&W provided by the seller(s). Some transactions have clauses stating that indemnity claims will not be paid for facts or circumstances already ascertainable via the due diligence conducted by the servicer, on behalf of the issuer, before closing. This implies that if a servicer did not conduct thorough due diligence, the issuer loses the right to be indemnified. It is worth noting that the share of the portfolio analysed during the due-diligence phase is typically high, above 50% of the total portfolio's GBV.

Indemnity process. Sellers and servicers (acting on behalf of issuers) discuss indemnity requests. The higher the indemnity requested, the higher the scrutiny by sellers and the longer before the issuer receives payment.

Commonly breached R&Ws

1. An incorrect mortgage lien is reported in the data tape;
2. The originator owns the documentation but it is incomplete and insufficient to work out the specific loan;
3. A non-valid mortgage;
4. Unsecured loans are classified in the data tape as secured loans;
5. Real estate assets are under confiscation;
6. Court cases raised by borrowers are still pending.

Appendix 2 – Italian NPL securitisations rated by Scope[5]

	Deal name/Link to Rating report	Issuance	GBV (million)	Scope class A rating		Scope class B rating		GACS (Y/N)
				At closing	Current	At closing	Current	
1	Elrond NPL 2017 Srl	17-lug-17	1,422	BBB-	CC	B+	C	Y
2	Bari NPL 2017 Srl	17-dic-17	345	BBB	C	B+	C	Y
3	Siena NPL 2018 Srl	18-mag-18	24,070	BBB+	BB+	Not Rated	Not Rated	Y
4	Aragorn NPL 2018 Srl	18-giu-18	1,671	BBB-	CCC	B	C	Y
5	Red Sea SPV Srl	18-giu-18	5,097	BBB	BB-	Not Rated	Not Rated	Y
6	4Mori Sardegna Srl	18-giu-18	1,045	A-	BB	BB-	CC	Y
7	2Worlds Srl	18-giu-18	1,002	BBB	CCC	B	C	Y
8	BCC NPLS 2018 srl	18-lug-18	1,046	BBB-	CCC	B+	C	Y
9	Juno 1 Srl	18-lug-18	957	BBB+	BBB+	Not Rated	Not Rated	Y
10	Maggese Srl	18-lug-18	697	BBB	CCC	Not Rated	Not Rated	Y
11	Maior SPV Srl	18-ago-18	2,749	BBB	BB	Not Rated	Not Rated	Y
12	IBLA Srl	18-set-18	349	BBB	BBB+	B	B	Y
13	AQUI SPV Srl	18-nov-18	2,082	BBB-	B-	Not Rated	Not Rated	Y
14	POP NPLS 2018 Srl	18-nov-18	1,578	BBB	B-	B	C	Y
15	Riviera NPL Srl	18-dic-18	964	BBB-	BB+	B+	CCC	Y
16	BCC NPLS 2018-2 Srl	18-dic-18	2,004	BBB	CCC	B+	C	Y
17	Belvedere SPV Srl	21-dic-18	2,541	BBB	CCC	Not Rated	Not Rated	N
18	Leviticus SPV Srl	19-feb-19	7,385	BBB	BB-	Not Rated	Not Rated	Y
19	Juno 2 Srl	19-feb-19	968	BBB+	BBB-	Not Rated	Not Rated	Y
20	Prisma SPV Srl	18-ott-19	6,057	BBB+	BB-	B-	CC	Y
21	Marathon SPV Srl	05-dic-19	5027	BBB+	A+	BB	BBB	N
22	Iseo SPV Srl	16-dic-19	858	BBB	BB	Not Rated	Not Rated	Y
23	Futura 2019 Srl	16-dic-19	1,256	BBB	BBB+	Not Rated	Not Rated	N
24	BCC NPLs 2019 S.r.l.	19-dic-19	1,324	BBB+	BB-	B-	CCC	Y
25	POP NPLs 2019 S.r.l.	23-dic-19	826.7	BBB	BB+	CCC	CC	Y
26	Diana SPV Srl	20-giu-20	1,000	BBB	BBB+	Not Rated	Not Rated	Y
27	Spring SPV Srl	20-giu-20	1,377	BBB	BBB+	Not Rated	Not Rated	Y
28	BCC NPLs 2020 S.r.l.	30-nov-20	2,347	BBB	BBB-	CC	CC	Y
29	Relais SPV S.r.l.	11-dic-20	1,583	BBB	BB-	Not Rated	Not Rated	Y
30	Buonconsiglio 3 S.r.l.	14-dic-20	679	BBB	BB+	Not Rated	Not Rated	Y
31	Sirio NPL S.r.l.	16-dic-20	1,228	BBB	BBB	Not Rated	Not Rated	Y
32	Yoda SPV S.r.l.	18-dic-20	6,033	BBB	BBB	Not Rated	Not Rated	Y
33	POP NPLS 2020 Srl	23-dic-20	920	BBB	BBB+	CC	CC	Y
34	Titan SPV Srl	28-dic-20	335	BBB	BBB	Not Rated	Not Rated	Y
35	Summer SPV S.r.l.	30-dic-20	322	BBB	BBB	Not Rated	Not Rated	Y
36	Aurelia SPV S.r.l.	22-giu-21	1,510	BBB	BBB+	Not Rated	Not Rated	Y
37	Palatino SPV S.r.l.	25-giu-21	865	BBB	BBB+	Not Rated	Not Rated	N
38	Aporti SPV S.r.l.	28-giu-21	356	BBB	BBB	Not Publicly Rated	Not Publicly Rated	N
39	Olympia SPV S.r.l.	25-nov-21	2,168	BBB	BBB	Not Rated	Not Rated	Y
40	BCC NPLs 2021 S.r.l.	29-nov-21	1,312	BBB	BBB	CCC	CCC	Y
41	Buonconsiglio 4 S.r.l.	14-dic-21	579	BBB	BBB	Not Rated	Not Rated	Y
42	Grogu SPV S.r.l.	15-dic-21	3,077	BBB+	BBB+	Not Rated	Not Rated	Y
43	Ortles 21 S.r.l.	17-dic-21	1,834	BBB	BBB	Not Rated	Not Rated	Y
44	Bela 2022 S.r.l.	19-apr-22	475	BBB	BB+	Not Rated	Not Rated	N
45	Organa SPV S.r.l.	21-apr-22	8,503	BBB	BBB	Not Rated	Not Rated	Y
46	Itaca SPV S.r.l.	06-mag-22	1,128	BBB	BBB+	Not Rated	Not Rated	Y
47	Ifis NPL 2021-1 (Restructured)	28-lug-23	1,323	BBB+	BBB+	B	B	N
48	Andor SPV S.r.l.	18-dic-23	1,318	BBB+	BBB+	Not Rated	Not Rated	N

Source: Scope Ratings

[5] As of 06/06/2024. For further details please refer to https://www.scoperatings.com/.

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