NPL investors rightly cautious on Italian banking crisis

Gennaro Pucci, CIO and founder of European credit-focused manager PVE Capital, analyses Italy's current economic woes and the evolving interest in NPLs

If we look at what has happened to Italy's banks over the last three to four years no one – regulators, banks, politicians - has taken the right action regarding the non-performing loan (NPL) situation which has continued to worsen.

Italian banks' ratio of NPLs is at 17% of total loans as of March, according to European Banking Authority (EBA) reports, compared to the weighted average ratio of NPLs at EU banks of 5.7%. "The EU average NPL ratio is up to three times higher than in other global jurisdictions."

The problem has become very serious, and the banks are not adequately capitalised to face the current deflationary environment and consequences of future volatility.

Everything which can affect GDP growth prospects of the country and its public deficit ratio therefore impact the banking system and that is why regulators are finally asking banks to rectify the issue.

The banks have let this issue grow to a level which is very difficult to manage. There is a widely held view that the problematic loans losses are around €40bn, but I believe it is more appropriate to include *incagli* (substandard loans that have not yet defaulted) in the potential losses, which then increases total system losses closer to €100bn ($111bn). There is no escaping from this issue other than a bold public intervention in the system.

Cautious investors

Our perception is that the markets have reached a point where investors are sitting on the side-lines.

In the NPL markets the announcement of Atlante initially seemed to raise hopes amongst sellers that they could achieve higher prices and on the other hand we also saw some buyers willing to pay higher prices.

But then Brexit changed things once again. As a result of the UK's decision to leave the European Union, investor demand in the NPL market has reduced. We now see a lower demand for risk overall and I also think people are waiting to see what happens with the Atlante II deal and the Monte dei Paschi recapitalisation first.

On the day after the Brexit vote on 24 June we received calls from investors saying they were hitting the pause button and did not want to take extra risk at present. It is a temporary decision, but there is more caution surrounding Italy and particularly from investors in the US.

I haven't heard anything that suggests there is a credible solution for the banks at this stage. The overarching issue, which cannot be solved simply through the Atlante II deal, is that there is still a requirement for a large capital injection into the Italian banking system.

I think investors are right to be cautious. The authorities are trying to leverage as much as they can, but at present it is not yet clear where the money for Atlante II is going to come from.

Another consequence of Atlante is the impression that NPL prices are being inflated because of the presence of a large "systemic" buyer. In reality, no rational investor is willing to pay an off-market price unless it can have some indirect benefits.

We are working with small to mid-tier individual banks and many of them are faced with a difficult situation – if they sell their non-performing loan books at market prices they will eventually deplete all their capital.

Some investors are now paying much higher prices for NPLs than in 2015. At PVE we haven't been aggressive in buying recently because the risk premium we value in these markets does not allow us to bid at these levels. At this point in time, we feel that the levels paid by the market do not provide adequate compensation for risk taken.

Fund performance

PVE Capital was amongst the first investors to move in to this space and buy secured assets. Back in 2015, we paid around 20% of face value for them. Now the prices are hovering around the mid-30s which, as pointed out, does not truly reflect the risk there is in the market this year.

Our portfolio is almost entirely made up of secured assets, predominantly residential and commercial properties, located mainly in the centre and north of the country.

The catalyst for creating the portfolio in March last year was that the prices were extremely interesting at the time. We are still active in looking for investments and there is still a certain quantity of assets to buy, but ultimately what we need is clarity on whether banks will be able to sell. Apart from a few recent transactions, there hasn't been a lot of activity so far this year.

The underlying reason is the uncertainty which Atlante I and Atlante II have created. Banks are also waiting to see if Atlante II gets

off the ground and then envisage selling at higher prices. Meanwhile, investors wait to see how the proposal will affect the market.

We have deployed the available capital into our European Distressed Funds I and II and we are currently raising money for a third fund.

As the NPL situation has evolved, credit funds have started to not only look at buying NPLs, but they are also assisting banks in tackling some of the losses crystallised from the disposal of NPL portfolios. The idea is that you can give support by buying bank shares once they have sold their entire NPL portfolios and, in that way, provide much-needed capital. Consequently, EDF III – which we hope will raise around €500m ($559m) by the end of the year– will focus on both acquisitions of NPLs and also a variety of assets in the banking system.

Being able to tackle the problem from an NPL acquisition point of view and at the same time also looking to work on long-term partnerships with the banks offers a more relationship-based rather than purely transactional opportunity to enter into Italy's distressed market.

Our current portfolios have delivered around 15% for investors since launching in Q1 last year and we think the current reforms are now starting to have a positive impact.. The housing market has improved and we have finally seen some judicial execution processes positively concluded after the first auction, which hasn't been the case for many years, which is also quite a positive sign.

Macro and political risks

The European Central Bank and the Bank of Italy are really pushing banks to dispose of NPL portfolios. The ECB has the power to wind down banks if they believe they are not viable and as such they have the ability to dispose of assets when required. My impression is that the market is getting to the point where the concerns are significant enough to put far greater pressure on the banks than the regulators are currently expecting. In any case, it is important that the ECB has finally stepped up their efforts.

Nonetheless, any event which alters the political situation and economic prospects such as Brexit can be problematic for the NPL market, banks and for the country – Italy really cannot afford to absorb more macroeconomic shocks at this stage.

At PVE we have many years of experience working through European crises and it is very difficult to see how and when a concrete resolution will be put in place.

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On the political front, the October constitutional reform referendum will be aimed at streamlining and reorganising the Italian Constitution. If the prime minister loses, it will obviously be a major blow but I don't think it will bring about Matteo Renzi's resignation. I don't think it will be a Brexit style situation where we see lots of resignations.

The government is still trying to water down the referendum contents and I don't see it as a huge political risk at this stage.

ability of Italy to accept the solution. There is no solution simply contained within the proposals of Atlante I and Atlante II, the problems are much greater and we are now looking at constructive ways to approach the opportunity at this stage which can be more meaningful for investors.

Gennaro Pucci is founder of European credit manager PVE Capital, which is headquartered in London