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The Italian Unlikely to Pay Market

Is now the momentum?

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Disclaimer: PwC analysis are based on FY15, FY16, FY17 banks' financial statements (tab. A.1.6, A.1.7 and A.1.8) and Data Provider dataset

The Unlikely to Pay segment

The market in 2017 and our view on 2018

Foreword | The market in 2017 and our view on 2018

Last year, our report on the Italian Unlikely to Pay (UtP) market was entitled "Ready to tackle the challenge?" to underline the potential momentum of the Italian banks to address the issue of their non performing exposures classified as UtP.

One year later we can say that 2017 witnessed few and limited movements in the UtP market. As a matter of fact, the Italian banks are still working on the implementation of best practices in the management of their NPE (UtP included) and furthermore are still lingering and pondering on how to best structure and effectively implement disposal plans of their UtP exposures (sales of UtP, net of several bailouts, were limited in terms of numbers of transactions and in EUR volumes in 2017).

UtP is a major issue for the Italian banking system for several reasons. The NPE figures at the end of 2017 still show a huge amount of UtP (€94bn of GBV) in the books of the banks. By the end of 2017 the UtP reached and even surpassed the levels of bad loans in terms of NBV (€66bn vs €64bn respectively). Since the Italian UtP exposures are concentrated within a few top banks we believe that these players will pave the way for the identification and execution of differentiated structured deleveraging strategies for the entire system.

Alongside their massive gross and net figures accounted for in the banks financial statements, the UtP feature a massive stock of loans (circa 50%) which do not successfully emerge from their status and remain as UtP year after year. UtP is by definition a category of borrowers in temporary financial difficulties that the banks should manage in order to move them back into the performing category. The Bank of Italy reported that 62% of the restructuring agreements (which comprise most of the UtP exposures), after four years, are still in place and did not result in a positive or conclusive outcome.

When considering this class of exposure, it is critical to note that UtP is a complicated asset class requiring several alternative management solutions.

The UtP category may typically include borrowers featuring overdue instalments (similar to Past Due exposures) on the one hand, and on the other hand, borrowers whose critical financial situation could easily lead to the status of bad loans.

Between these two sub-categories UtP include all the exposures involved in some kind of restructuring measures. Moreover, UtP are different depending on borrower's characteristics, such as industry, size, vintage (how long the exposure is classified as UtP), available guarantees and collaterals (secured vs. unsecured). Each of the above characteristic may lead to different management and deleveraging strategies.

Will the Regulators' requirements for proactive management of NPE be a game changer for UtP? ECB guidelines, whose application in Italy will be extended across the board, even to the less significant banks, the calendar provisioning (within the ECB Addendum) providing for higher and faster provisioning for NPE, and the application of IFRS9 from 1 January 2018, all represent some of the extensive measures required by the Regulators. We believe that these recent requirements mandated by the European Regulators will undoubtedly drive the Italian banks' management of the current stock, next wave of NPE and the UtP deleveraging plans as well.

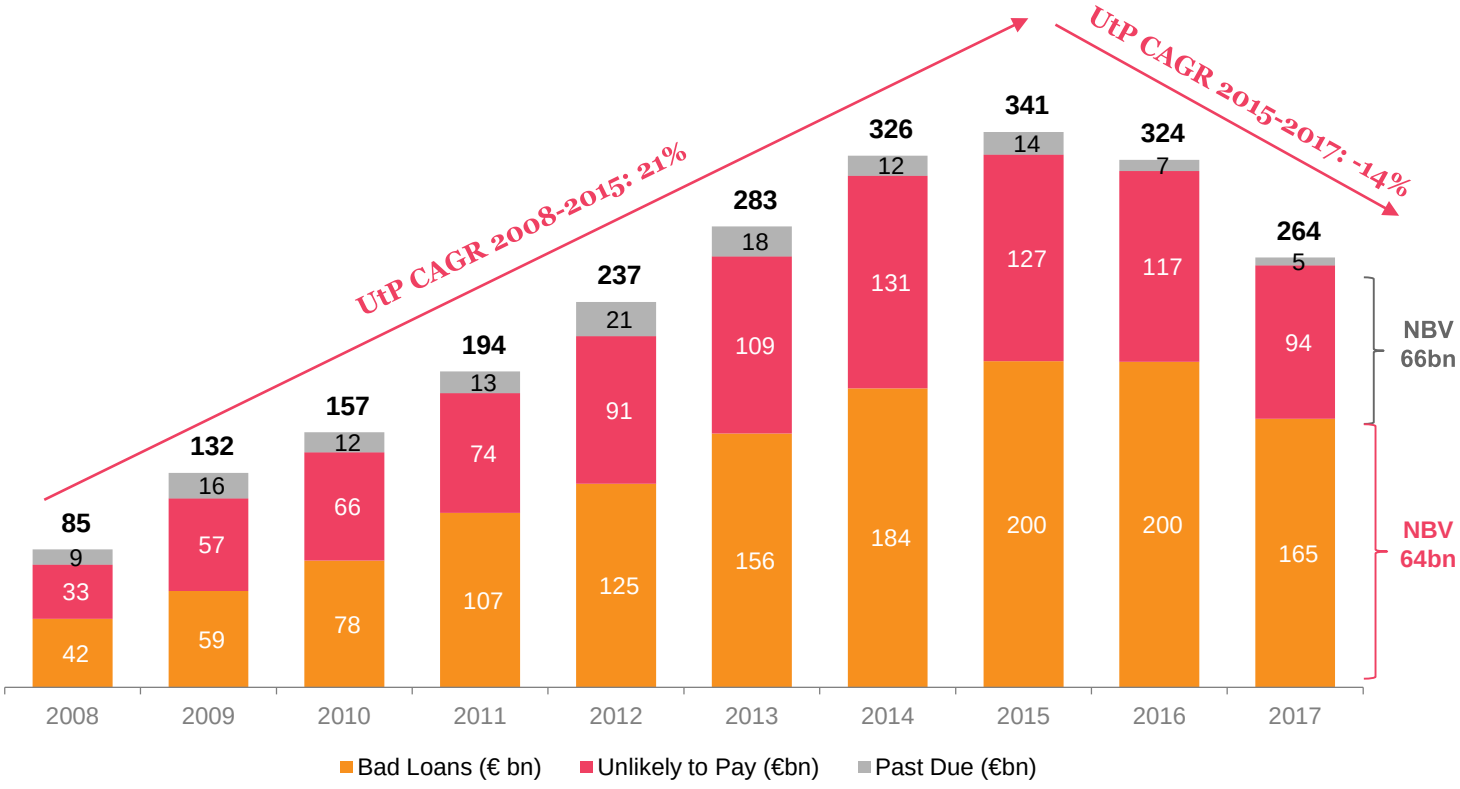
If the aforementioned assumption is true, which management and deleverage strategies will the Italian banks execute in 2018? Depending on their strategic drivers, the Italian banks could pursue one or more of the potential strategic options which would be aimed at deleveraging their UtP. Capital requirements and short/medium-term plans of reducing their NPE ratio could lead to massive UtP sale opportunities (single names and/or small portfolios). Industrial capabilities' self-assessment along with identification of potential upside coming from the proper restructuring of the UtP could even lead the banks to internal management or external management (through specialised servicers) of the UtP.

We also see in the market a rising interest in structuring and executing securitization operations with UTP as underlying assets that could introduce a disruptive and innovative solution in facing the Italian UtP issue.

We believe that 2018 is definitively the right moment for the Italian banks to firmly and decisively progress on their path to tackle the UtP challenge.

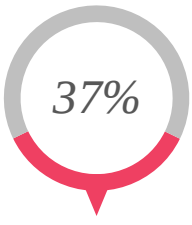
1 Asset Quality and Unlikely to Pay key figures

The Non Performing Exposures ("NPE") volume in the Italian banking sector reached a gross amount of €264bn, of which €94bn are classified as Unlikely to Pay ("UtP"). UtP even surpassed Bad Loans in terms of net book value (€66bn vs €64bn respectively).

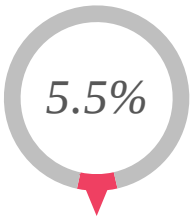


Source: Bank of Italy Report – «Condizioni e rischiosità del credito» updated Dec17

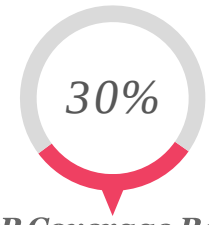
UtP Key Figures



Gross UtP/ NPE Ratio
(Average - Top 10 banks)*



Gross UtP Ratio
(Average - Top 10 banks)*



UtP Coverage Ratio
(Average - Top 10 banks)*

(*) Calculated as arithmetic average

2 Unlikely to Pay distribution – Top 10 Italian banks

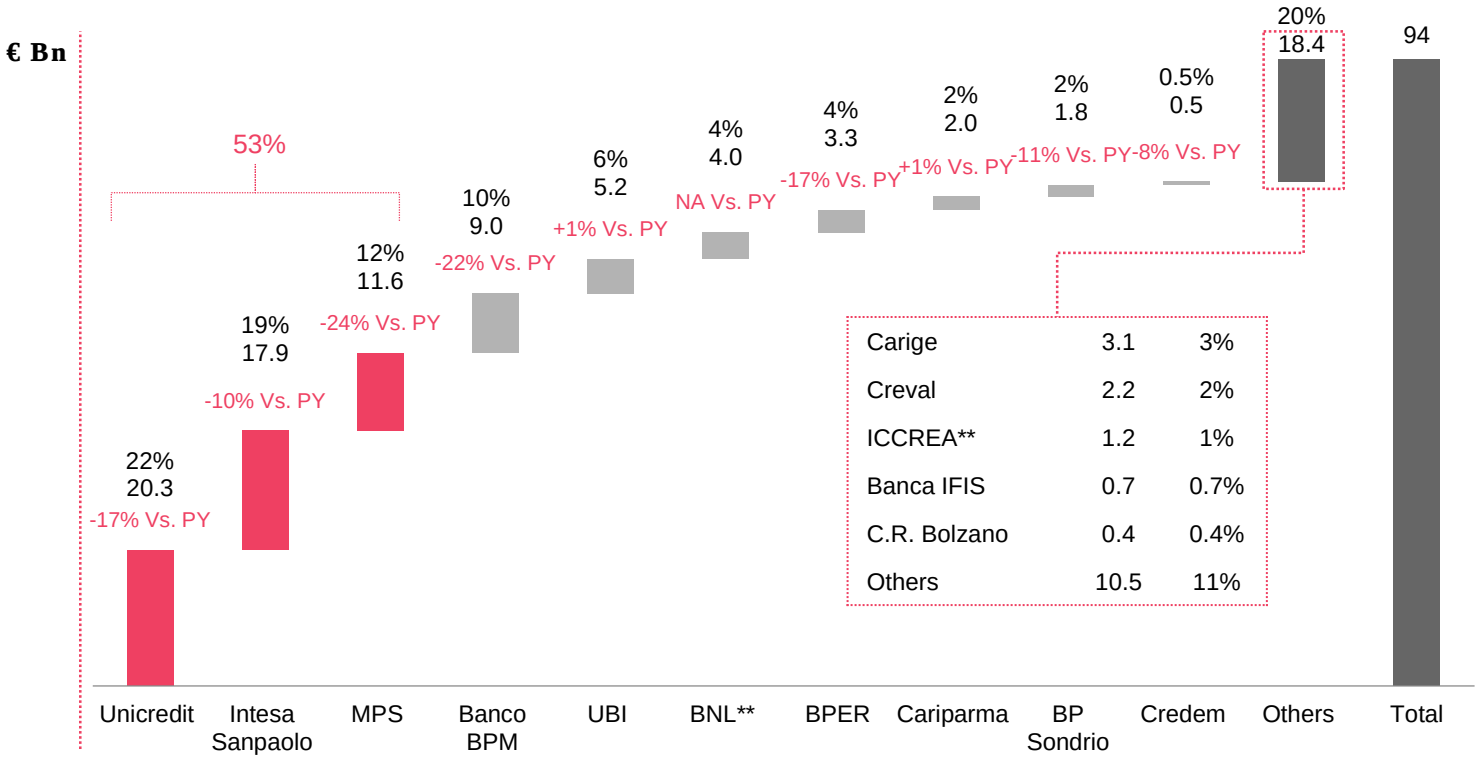
At the end of FY 2017, the UtP exposure amounted to €94bn (GBV) of which 80% is concentrated within the top 10 banks. Despite the declining trend the UtP magnitude is still huge.

*UtP among Top 10 Italian banks**

At the end of 2017 the overall UtP exposure is highly concentrated within the Top 10 Italian banks (80% of the total UtP exposure vs 76% in 2016); when considering only the Top 3 Italian banks, such percentage is 53% (51% in 2016).

The UtP exposure declining trend, started in 2015 (-3% from FY 2014 to FY 2015), continued in 2016 and 2017 (-8% and -20% YoY respectively).

Despite the declining trend, UtP stock is an issue to be tackled promptly: 37% of the NPE of the Top 10 Italian banks are UtP as at 31Dec17, with several banks (4 out of 10) featuring gross UtP ratio on NPE over 40%.



Carige	3.1	3%
Creval	2.2	2%
ICCREA**	1.2	1%
Banca IFIS	0.7	0.7%
C.R. Bolzano	0.4	0.4%
Others	10.5	11%

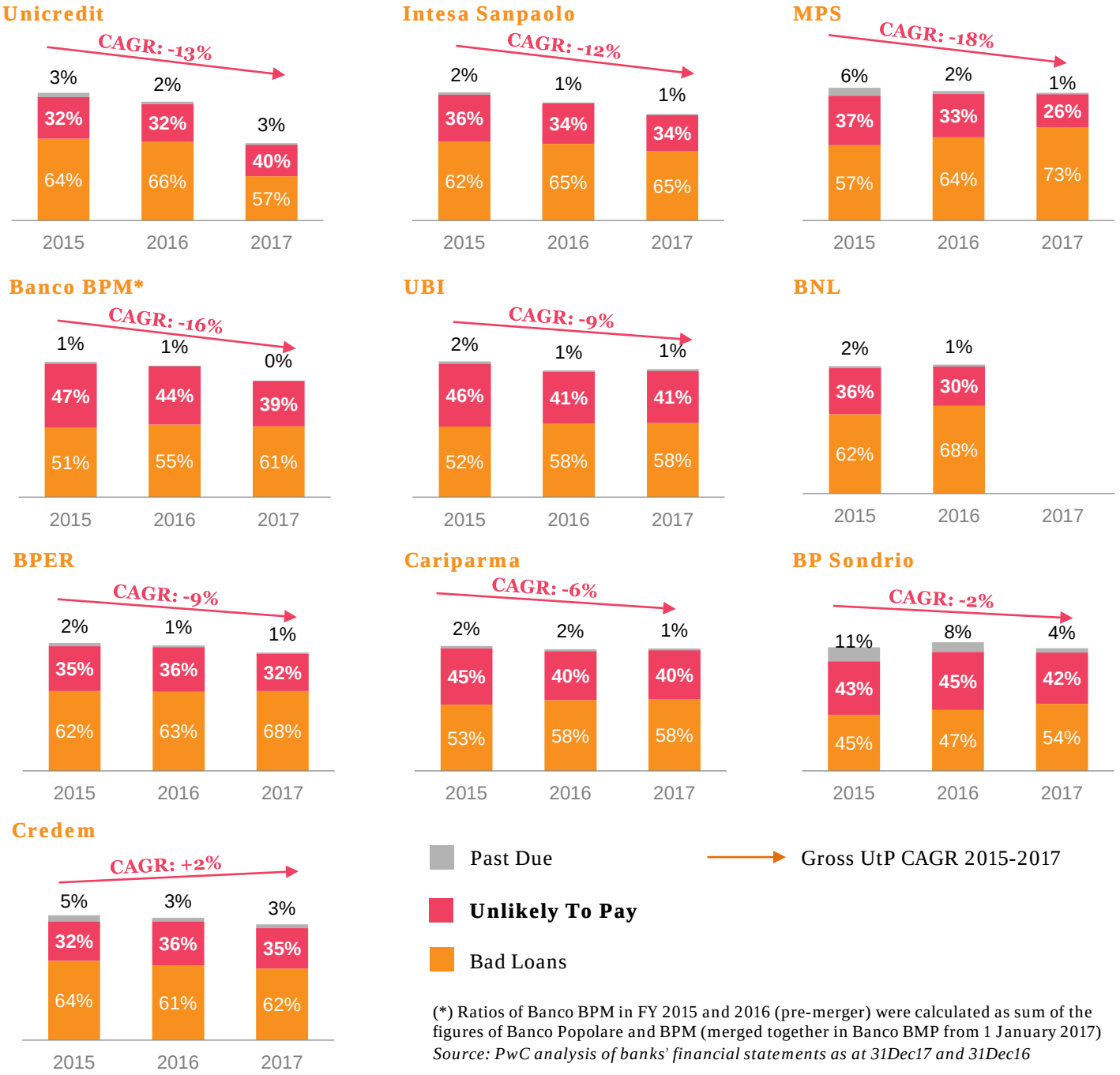
	Unicredit	Intesa Sanpaolo	MPS	Banco BPM	UBI	BNL**	BPER	Cariparma	BP Sondrio	Credem
Gross UtP/ NPE	40%	34%	26%	39%	41%	30%	32%	40%	42%	35%
Gross NPE Ratio	11%	12%	37%	20%	13%	19%	20%	11%	15%	5%

(*) The list of Top 10 Italian banks is based on the Gross Book Value of Total Exposure as at 31Dec16 (source: ABI)
(**) BNL exposure as at 31Dic16 (to date their financial statement as at 31Dec17 is not available); ICCREA exposure as at 30Jun17
Source: PwC analysis of banks' financial statements as at 31Dec17

3 UtP Ratio on NPE – Breakdown of Top 10 Italian banks

Despite the gross UtP exposure declining trend over the period 2015 / 2017 (CAGR of -14%), their weight on the NPE of the Top 10 Italian banks remains significant (37%).

NPE breakdown from 2015 to 2017 by bank



(*) Ratios of Banco BPM in FY 2015 and 2016 (pre-merger) were calculated as sum of the figures of Banco Popolare and BPM (merged together in Banco BMP from 1 January 2017)

Source: PwC analysis of banks' financial statements as at 31Dec17 and 31Dec16

4 Unlikely to Pay coverage ratio - Top 10 Italian banks

The UtP average coverage ratio of the Top 10 Italian banks reached 30.4% (29.1% in 2016) while their ratio on total loans declined from 6.5% to 5.5%. The Italian banks are on the right path but further efforts are required.

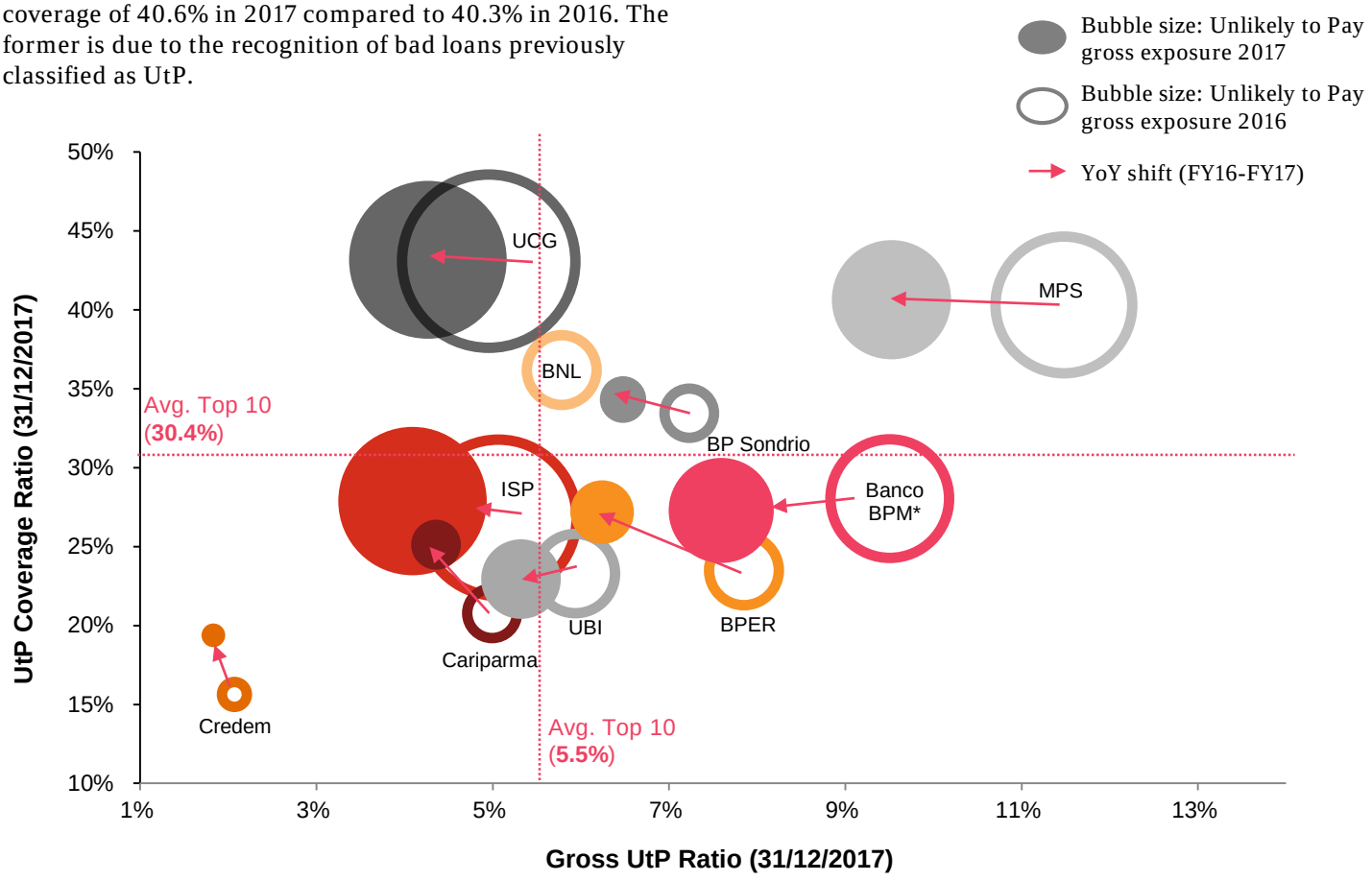
UtP Coverage ratios vs. Gross UtP ratios

Top 10 Italian Banks featured general higher provisions of UtP in 2017 vs 2016, resulting in higher coverage ratios (avg. 30.4% in 2017).

In particular UniCredit and Intesa Sanpaolo, both below the average Gross UtP ratio (4.3% and 4.1% respectively), increased their UtP provisions reaching UtP coverage equal to 43.2% (UniCredit) and 27.9% (Intesa Sanpaolo) at the end of 2017.

MPS, third bank in terms of UtP exposures, showed gross UtP ratio (9.5%) lower than in 2016 (11.5%) with an average UtP coverage of 40.6% in 2017 compared to 40.3% in 2016. The former is due to the recognition of bad loans previously classified as UtP.

Ratios of Banco BPM* showed a reduction of the gross UtP ratio (7.6% in 2017 vs 9.5% in 2016) as well as UtP coverage (27.3% in 2017 vs 28.0% in 2016). Likewise, UBI dropped its Gross UtP ratio from 5.9% to 5.3% and UtP Coverage from 23.3% to 22.9%.



(*) Ratios of Banco BPM in FY 2016 were calculated as sum of the figures of Banco Popolare and BPM

Source: PwC analysis of banks' financial statements as at 31Dec17 and 31Dec16

5 Unlikely to Pay inflows and outflows from 2015 to 2017 – Top 10 Italian banks

At the end of 2017, despite the decreased outflows to bad loans (-5%) and inflows from performing (-2%) compared to 2016, 50% of UtP remained as such. The UtP issue for 2018 still lies in the management of their massive stock.

Outflows and Inflows

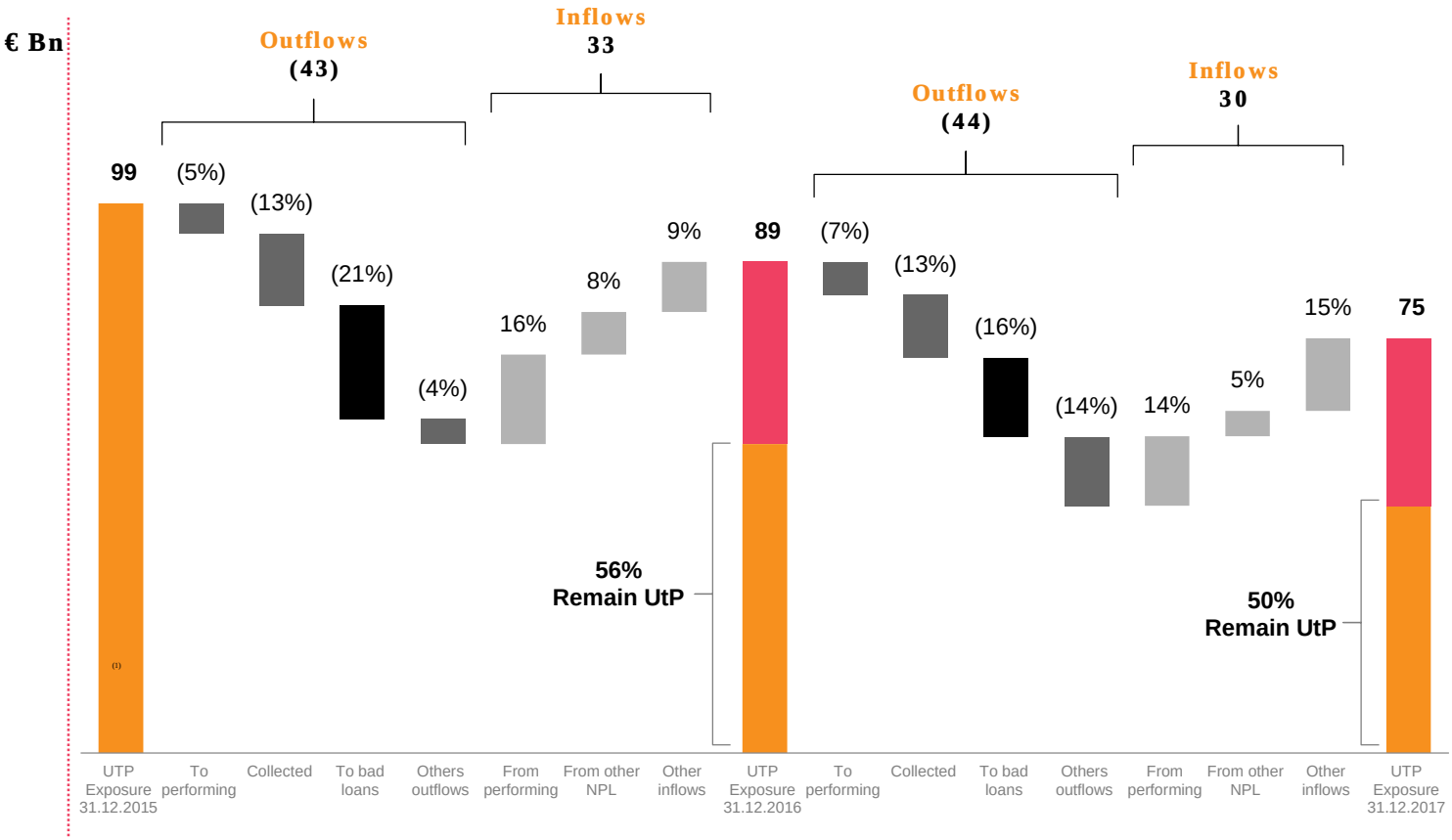
In 2017, total outflows of the Top 10 Italian banks remained stable at around €44bn, despite lower outflows to bad loans: 21% in 2016 vs 16% in 2017*.

The inflows in 2017 decreased from €33bn to €30bn, mainly due to the lower inflows from performing and past due exposures*.

$$\% \text{ flows} = \frac{\text{UtP In/Outflow}}{\text{Initial UtP exposure}}$$

In particular, UtP gauged a firm decline of inflows from performing loans over the last 2-year period: 16% in 2016 vs 14% in 2017*.

UtP which remained UtP during 2017 amounted to €44.5bn (i.e. 50% out of €89bn), proving how the main issue for the Italian UtP lies mainly in their massive stock and a management not yet able to target deleverage solutions.

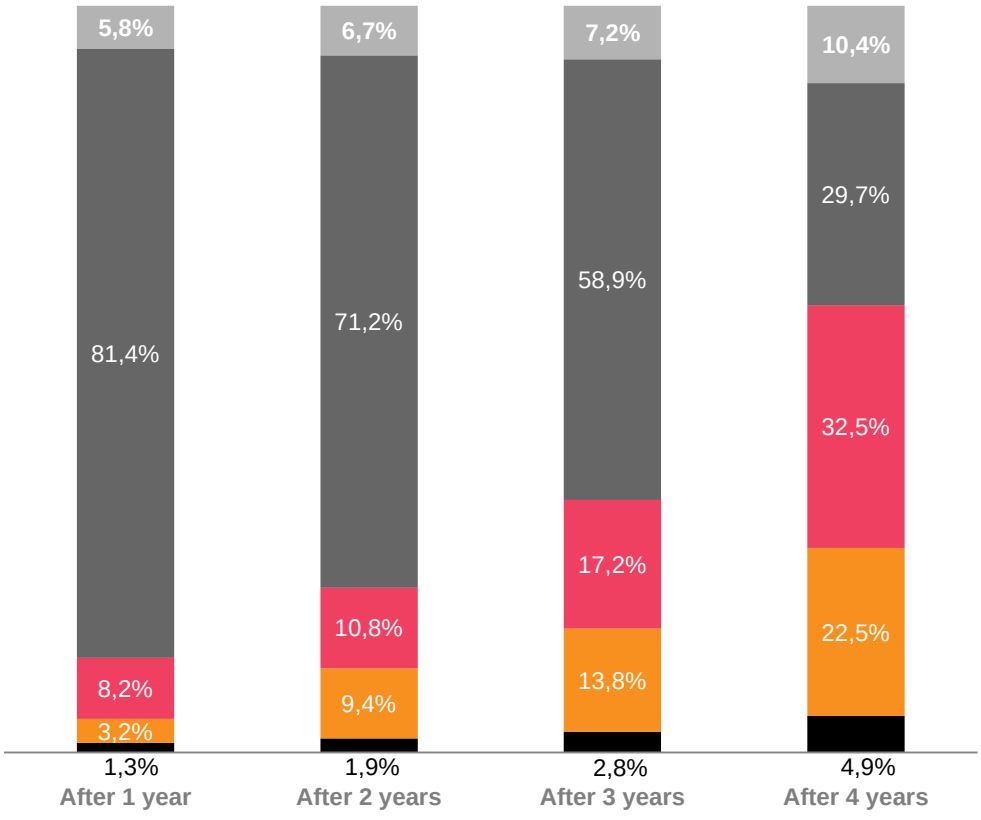


(*) Inflows and outflows in 2017 for BNL were estimated equal to the flows occurred in 2016
Source: PwC analysis of banks' financial statements as at 31Dec17 and 31Dec16

6 Restructured loans trend within the Italian banking system

The issue of the massive stock of the UtP lies in the lack of effectiveness of the traditional restructuring measures carried out so far by the Italian banks. According to Bank of Italy 62% of the restructuring agreements (which qualify most of the UtP exposures) after 4 years are still in place and have not resulted in a positive and conclusive outcome.

Restructured exposures' trend*



According to Bank of Italy, after 4 years:

- 62.2% of the restructuring agreements (which qualify most of the UtP exposures) are still in place
- 22.5% of the restructuring agreements resulted in liquidation/bankruptcy procedures)
- 10.4% of the restructuring agreements resulted in a positive and conclusive outcome

(*) This trend is related to the years from 2010 to 2014 (restructuring processes begun in 2010). By «Restructured exposures» Bank of Italy refers to exposures subject to the following procedures according to the Italian Bankruptcy Law:

- «Concordati preventivi»
- «Accordi di ristrutturazione»
- «Piani di risanamento»
- «Accordi stragiudiziali»

Source: Bank of Italy – «Questioni di Economia e Finanza» (No. 311, March 2016)

7 The UtP is a complicated asset class thus requiring several alernative management solutions

The challenge of UtP management is not only about their magnitude (€94m of GBV) and their fixed stock (50%), but it also concerns their intrinsic complexity as an asset class.

Clustering the UtP exposures

Not all UtP exposures are equal. According to Bank of Italy criteria, the UtP are classified as such according to the judgment of the banks about the debtor's unlikelihood to fulfil its credit obligations.

As a result UtP category may include on one end borrowers featuring overdue instalments (similar to Past Due exposures) and on the opposite end borrowers whose critical financial situation could lead easily to the status of bad loans.

Between these two sub-categories UtP include all the exposures involved in some kind of restructuring measures.

Moreover, UtP are different depending on borrower's characteristics, such as industry, size, vintage (from how long the exposure is classified as UtP), available guarantees and collaterals (secured vs. unsecured).

Each of these features must lead to a specific management strategy for the UtP. Therefore, the punctual comprehension of the UtP characteristics is essential for their proper and effective management by the Italian banks.

Type of borrower

Type of UtP	Industry	Size	"Vintage"	Collateral
UtP "Overdue"	✓	✓	✓	✓
UtP "under restructuring" (Recovery plans ex art. 67 & art. 182bis Italian Bankruptcy Law, other restructuring procedures)	✓	✓	✓	✓
"Non performing" UtP (Almost bad loans)	✓	✓	✓	✓

8 UtP performance from 2015 to 2017 - collections and returns to performing

UtP collections and returns to performing, even thought the figures remain low, increased from 2015 to 2017. Only through proactive management of UtP, will cure rates and collections further improve.

Performance Top 10 and total Italian market

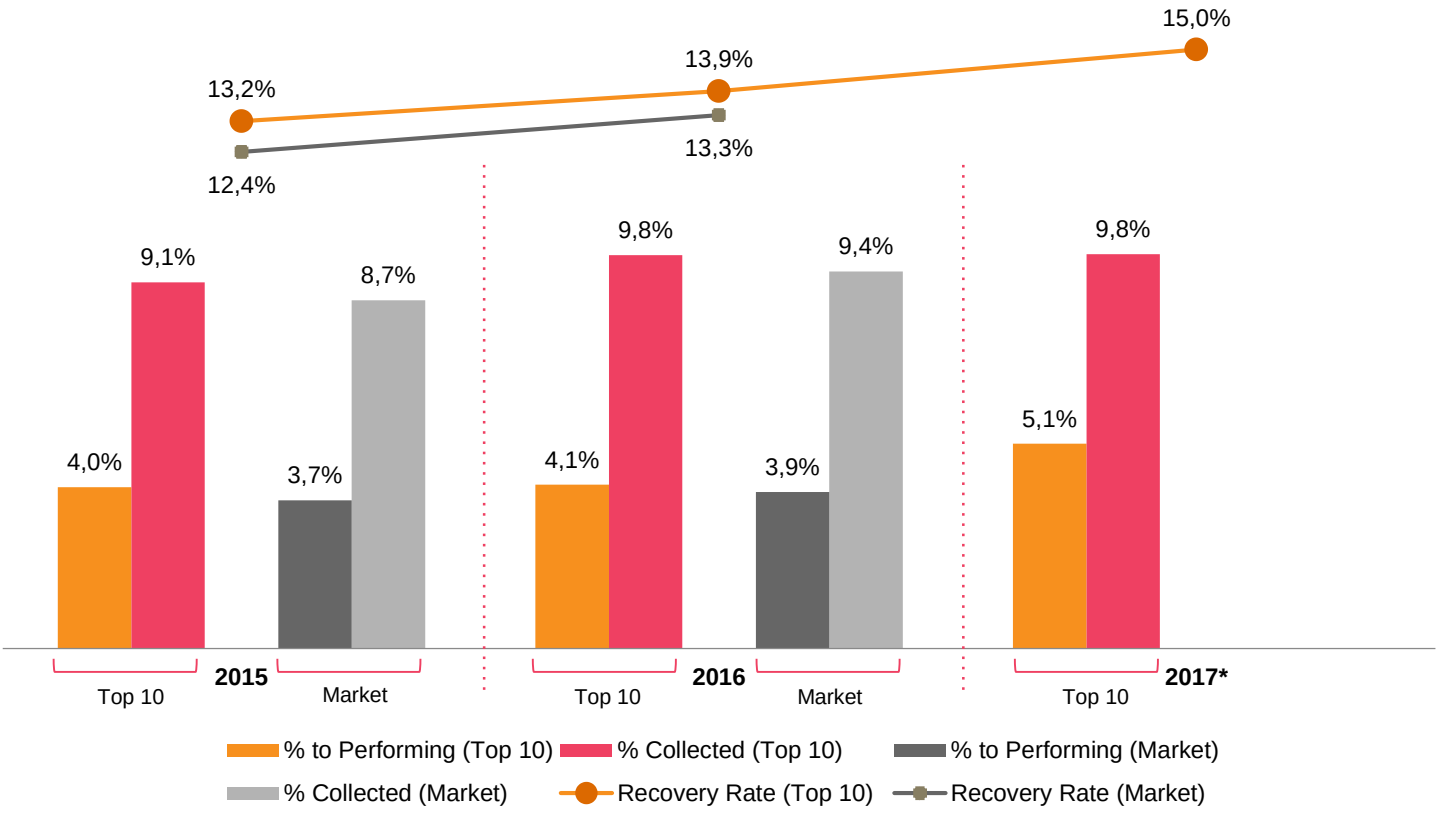
For the Top 10 Italian banks, the portion of UtP returned to performing increased from 2015 (4.0%) to 2017 (5.1%).

A similar trend for the cure rate was confirmed even for the Italian banking market (3.7% in 2015 v.s. 3.9% in 2016).

For the Top 10 Italian banks, the collections of UtP increased over the period 2015-2017 from 9.1% to 9.8%.

In general, Top 10 banks outerformed the overall market in 2015 and 2016, both in cure rates and collections.

$$\text{Recovery rate (\%)} = \frac{\text{UtP Exit to performing + Collections}}{\text{UtP Initial exposure + Inflows}}$$



(*) Figures for 2017 do not include returns to performing and collections for BNL

Sources: PwC analysis of banks' financial statements as at 31Dec17, 31Dec16 and 31Dec15, and of data provided by ABI «Associazione Bancaria Italiana»

9 Will the Regulators' requirements for proactive management of NPE be a game changer for UtP?

Regulatory issues often have material impact on banks' decisions. Central banks, Authorities, Lawmakers and Standard Setters have been pushing banks to proactively manage their NPL exposures. We believe that these influences will be a game changer for the management of UtP.

List of recent regulatory changes related to Non Performing Exposures

ECB & Bank of Italy

- **ECB's NPEs Guidance** (March 2017)
- **Calendar Provisioning** (**Addendum ECB**): "Prudential provisioning backstop" equal to 100% after 7 years of vintage for secured NPE, 2 years of vintage for unsecured NPE
- Bank of Italy extended ECB Guidance also to **Less Significant Institutions (LSI)**

European Authorities

- **Action Plan**, aimed at involving EU Institutions (including European Commission) into the adoption of best practices for the management of the NPE stock
- **EBA Guidance** about NPE's appropriate classification and sustainable management, and about forborne exposures

Lawmakers

- "**GACS**" is aimed at increasing liquidity in the market by facilitating leverage on portfolio disposals
- **EU Directive** about credit servicers and purchasers and about collateral recovery plans
- **EU Regulation "Anacredit"** for the collection of granular data on EU banks' credit exposures

Accounting Standards (IFRS 9)

- Entered into force in 1 January 2018, IFRS 9 introduces an "**early warning and forward looking approach"** to credit impairment testing methodology, resulting in the classification of certain portions of the current portfolio in loans' higher risk categories
- Banks will be required to **accrue provisions based on expected losses** and not only upon the occurrence of specific events

10 What should banks do to tackle the UtP challenge? The answer is "proactive management"

UtP need to be moved out of their hybrid status. Banks should carry on portfolio segmentation to better understand their UtP asset quality as well as implement a due diligence approach on a single name basis to identify the optimal strategy for their UtP. Solely through this proactive management will the optimal deleverage strategic option be identified.

Our view on what banks should do for a proactive management of UtP

1. Carry on **portfolio segmentations** for
(i) a better understanding of the asset quality of their UtP
(ii) a proper portfolio classification
(iii) a preliminary identification of management strategies

2. Assess **borrowers' performance** throughout the analysis of financial statements, intermediate reports, Business Plan, Budget and any further financial documentation about the borrowers' performance and details of their financial position

3. Regularly monitor the **Central Credit Register** to be informed on the total exposure to the system and relevant movements (overdraft withdrew or decrease, bad loan classification)

4. Use **early warning indicators**: from internal (companies and individuals) and external sources

5. Produce and regularly update an **overall rating** on borrowers' risk based upon info gathered from several sources

6. Implement **improved NPE operating model**: dedicated workout units, procedures for classification and segmentation, tailor made management strategies on a single name basis

Operational risks
(risks concerning the operational structure of the borrowers)

Market risks
(external variables such as those regarding the environment where the borrowers operate)

Financial risks
(financial soundness of the borrowers and / or relevant customers and / or suppliers)

11 Which strategic options are available to fix the UtP issue?

Following the improved proactive management pushed by the Regulators, banks could identify the most effective and efficient solutions to deleverage their UtP (e.g. return to performing, collection) among several strategic options. Solely a proactive management of UtP could lead to the right "tailor made" strategic solution.

Our view on the available strategies for UtP

The strategic options identified through the on going due diligence carried out by the bank on the borrower's case could result in the return of the loan in the performing category through the implementation of internal forbearance measures or in the sale of the loan or in the classification of the exposure as bad loans (thus requiring the prompt liquidation of the borrower's asset through judicial procedures)

Sale of UtP could be even executed through portfolios transactions which require preliminary strategic segmentation to maximize loans' value for the banks.

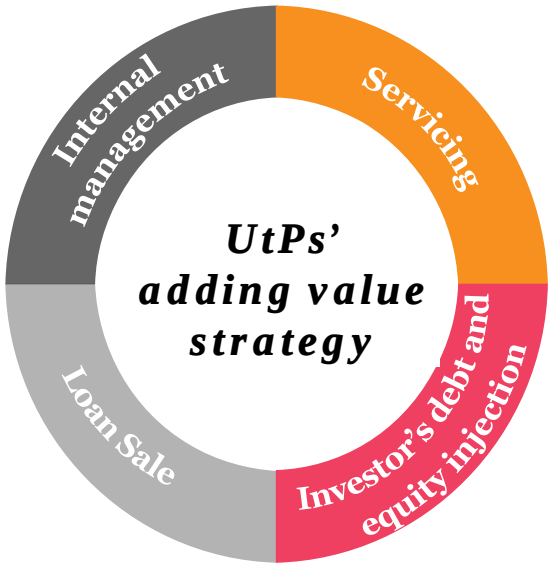
Otherwise, banks may decide to outsource the management on NPE (such as UtP) to a specialised credit servicer.

Internal management

- Forbearance measures:
  - Grace period/Payment moratorium
  - Extension of maturity/term
  - Debt consolidation
  - New credit facilities
  - Recovery plan by Italian Bankruptcy Law (e.g. art. 67 & 182 bis)
- Segmenting by industry/ type of UtP (overdue/ restructured/ defaulted)

Servicing

- New opportunities of value creation
- New market opportunities
- Mandatory will be the transition from past due management to a proactive management of the UtP (e.g. new credit facilities)
- Part of the industrial management required by ECB
- Best practices' implementation



Loan sale

- True sale/securitisation
- Single names' sale on a best offer basis (opportunistic criteria)
- Single names' sale based on a structured plan (strategic criteria)
- Sale of UtP portfolios

Investor's equity injection/ underwriting of senior debt

- Industrial partner to revamp and establish the underlying borrower's business (long term approach)
- Financial partner to inject cash within a strategic exit plan (short/medium term approach)

12 ECB Guidance on forbearance measures

Internal management

Italian banks should improve their loans' restructuring procedures throughout an appropriate and more effective "case by case" analysis of the financial difficulty of the borrower.

The ECB Guidance on forbearance

The ECB guidance emphasizes that the main objective of forbearance measures is to allow debtors to exit their non-performing status or to prevent performing borrowers from reaching a non-performing status.

Therefore, the guidance actively addresses the theme, by guiding banks in the identification of the optimal balance of forbearance measures aimed at granting the exit from short- and long-term difficulty status of the debtor.

In particular, on the basis of the type of difficulty of the debtor, either short- or long-term forbearance measures (or a combination of the two) maximizing recoveries shall be identified, by granting, simultaneously, the sustainability of the adopted measures (e.g. debt service capacity).

Main forbearance measures* – Application examples

Area of intervention	Adoption of short-term measures		Adoption of long-term measures	
	Financial difficulty	Measure	Financial difficulty	Measure
Interest	• Temporary financial difficulty of minor entity to be overcome within 24 months	• Temporary payment of **interest only** (no capital reimbursement)	• Excessively high interest rates for the debtor	• **Permanent reduction** of interest rates
Instalments	• Temporary financial difficulty of moderate entity to be overcome within 24 months	• **Temporary reduction** of instalment amount • Full interest payment	• Misalignment between repayment plan and reimbursement capacity of the debtor	• **Rescheduling** of amortization plan (e.g. partial, bullet, step-up)
Maturity	• Temporary financial difficulty of moderate/ serious entity to be overcome within 24 mo.	• "**Grace period**" for the payment of interests and capital	• Excessively high instalments for the debtor	• **Extension** of debt maturity
Collateral			• Permanent difficulty and good level of collateralization	• **Voluntary disposal of collateral** by the debtor

*In **particular cases** it is possible to adopt **new credit facilities** or **debt consolidation** measures*

(*) In addition to debt forgiveness and/or arrears capitalisation options

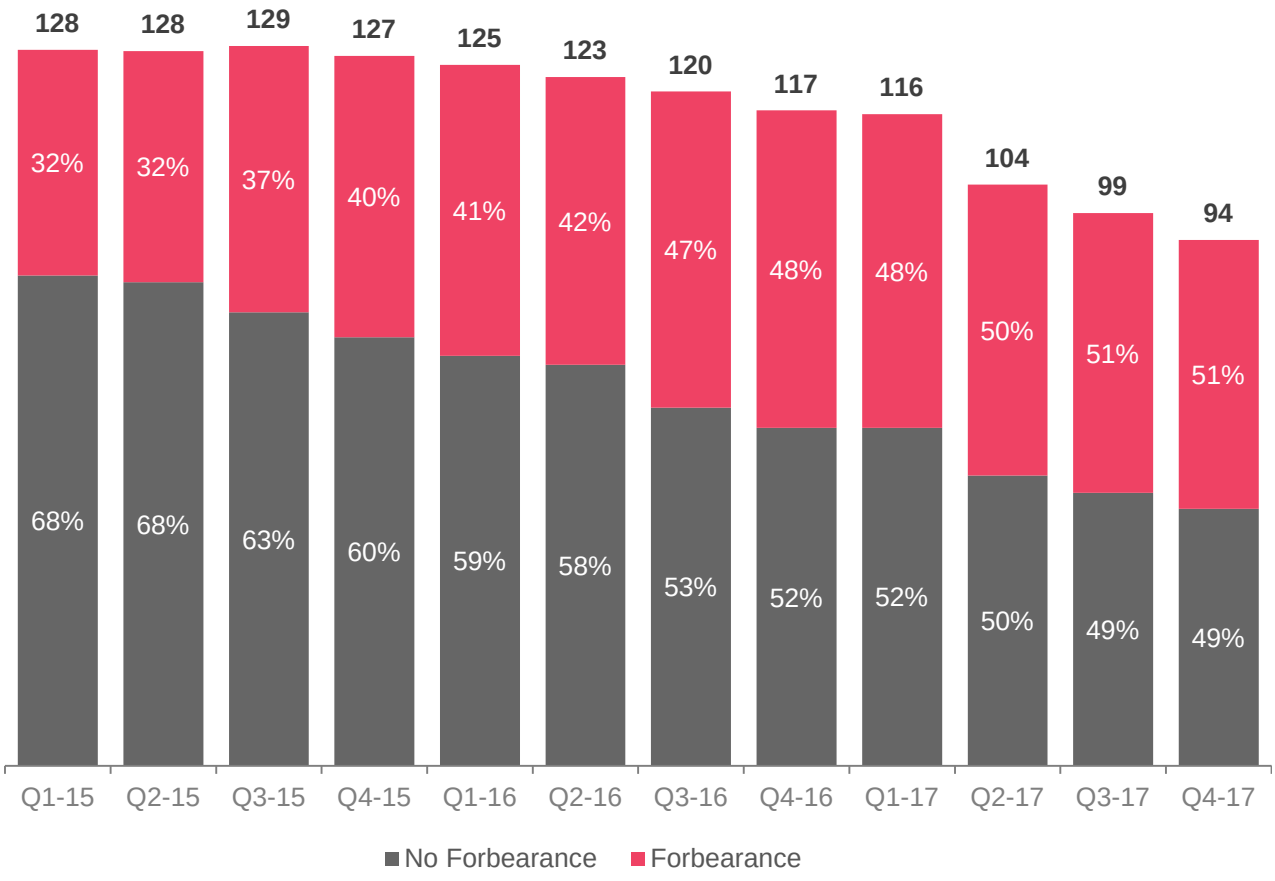
13 Forbearance measures' trend from 2015 to 2017

Internal management

UtP exposures subject to forbearance measures increased from €40bn in Q1 2015 to €48bn in Q4 2017, and forbearance ratio reached its peak at 51% of total UtP exposures (vs. 32% in Q1 2015).

Italian banks' forborne UtP exposures (€ bn)

$$\text{Forbearance Ratio} = \frac{\text{Forborne UtP exposures}}{\text{Total UtP exposures}}$$



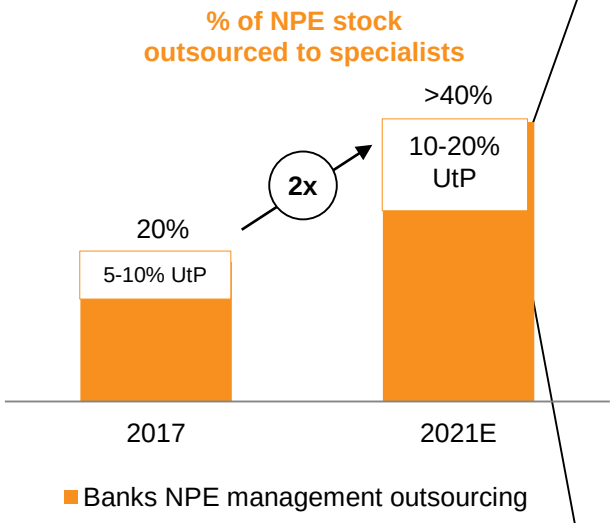
Source: Bank of Italy Report – «Condizioni e rischiosità del credito» updated Dec17

14 Servicing of UtP as a new market opportunity

Servicing

Outsourcing the UtP is the next frontier of NPE servicing. The specialized servicers must migrate from a traditional management of overdue UtP exposures to a proactive management of UtP, thus entailing new lending and restructuring measures as strategic management options.

The UtP servicing could increase significantly over the next four years along with the volumes of NPE outsourced by banks and investors to external specialised servicers.



Conditions to be satisfied by the Servicers for the management of UtP

New lending – Throgh the on going management of the existing loan contracts, *servicers must secure: 1) new injection of cash (debt and/or equity) into the UtP borrowers' capital structure, directly (e.g. challenger banks) or indirectly (through third party investors) and 2) support in defining restructuring plans.*

Management – *Servicers must carry on a proactive management of the UtP borrowers on a daily basis. Essential is the relationship established with the borrowers and the knowledge of their local market.*

IT Platform – *Servicers must migrate the UtPs management on advanced IT platform aiming at promptly managing the relevant information about the borrowers.*

Strategies – *Servicers must identify the proper management strategy of the UtP borrowers through the continuous assessment of their performance, early warning indicators, KPI.*

15 UtP portfolios and single names transactions in 2017

Loan sale

In 2017 UtP transactions, excluding the ones realised in context of banks' bailouts, have been limited in terms of amount and volumes. We believe that the market of UtP transactions is about to start in 2018.

Market transactions of UtP portfolios and single names in 2017

	Seller	Buyer	€ mln
Banks' bailouts	Veneto Banca, Banca Popolare di Vicenza	SGA	9.000
	Banca Marche, Etruria, Chieti	Quaestio Capital SGR + Credito Fondiario	2.200*
	CRC – Carim – Carismi	Quaestio Capital SGR (mezzanine) + FIDT (junior)	2.800*
	Carife	Quaestio Capital SGR + Credito Fondiario	376*
Other transactions	CreVal	Credito Fondiario	104
	CRC – Carim – Carismi	Algebris Investments	286
	CreVal	Algebris Investments	245**
	Commerzbank	Fortress Inv. Group	234*
	CreVal	Cerberus	105
	Hypo Alpe Adria Bank S.p.A.	Bain Capital Credit	750*
	UniCredit S.p.A.	Stinger SPV Srl	35
	CreVal	Hoist Finance	24
	UniCredit S.p.A.	DeVar Claims SPV Srl	na

(*) Mixed portfolio of UtP and Bad Loans
(**) Transaction closed in Q1, 2018

16 Investor's equity injection/underwriting of senior debt

Investors' equity injections

The UtP market features structured transactions where specialized investors (distressed and turnaround) inject new equity or debt in distressed companies within a strategic exit plan in the short-medium run (speculative view) or in the long run (industrial view). Specialized players are introducing new solutions for the banks to inject new finance in their borrowers and to reduce their NPE ratios.

Deal structure	Type of investor	Derecognition for the banks
Buyout of single-named UtP aimed at revamping the business throughout debt consolidation and proactive management of target company	Private Equity Funds (distressed value investing in equity)	Banks can derecognise the loan through a true sale
Synthetic securitisation of non-performing exposures, potentially secured by GACS	Acquirers of asset-backed securities (including the banks originators underwriting the SPV notes) along with investors with different risk profile	Banks cannot derecognize the loan if hold the credit risk through the junior notes of the SPV
Acquisition of target company with debtor-in-possession (DIP) financing to realise new investments. Often the investment vehicle/ fund is participated by selling banks	Private Debt Funds investing in distressed companies	Banks can derecognise the loan and replace it with shares of the investment vehicle/ fund
Creation of an all-equity SPV, fully provided with cash; merger of the SPV with target bank; use of SPV's raised cash to underwrite senior debt/ equity of distressed companies with the purpose of business recovery	SPAC (Special Purpose Acquisition Company)	Banks can derecognise the loan through a true sale

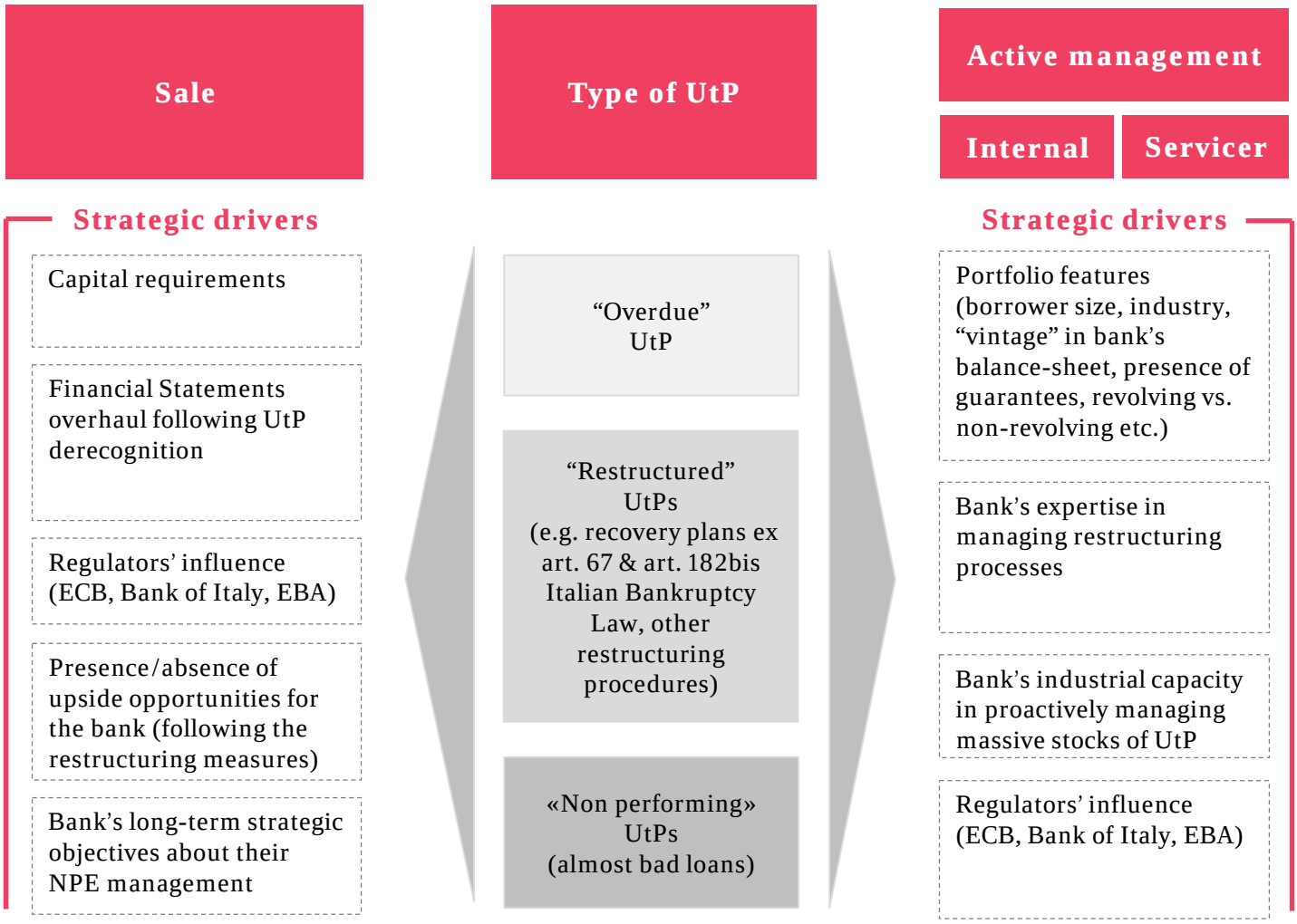
17 View on 2018 - Strategic drivers will lead the banks' decisions on their UtP management

Will 2018 be the year of loans' sales or active management (internal/ external throughout a servicer)?

As discussed above, there are four different possibilities of managing UtP exposures. These options imply the true sale (derecognition) or the active management of UtP exposures.

In turn, active management could be either implemented by the bank itself or a servicer.

The decision of retaining or selling UtP portfolios/ single names (and, if retained, the choice between internal and external management) will be driven by several strategic drivers, entailing regulatory requirements, accounting principles, banks' industrial capability and expertise, long term vision of their NPE management.



Appendix

How will the IFRS9 affect UtP?

Starting from FY 2018, we expect that a higher portion of loans might be at risk of being reclassified as higher risk loans' categories following the introduction of a different valuation approach (from "ex post" to "forward looking").

Our view on the requirements stemming from the adoption of IFRS9 by the Italian banks

The transition to IFRS 9 (from IAS 39) will be critical as banks will be required to accrue provisions based on expected losses and not only upon the occurrence of specific events (e.g. "impairment tests"). Banks will be asked to adopt a "forward looking" approach and as such to anticipate losses at the first signals of deterioration.

As a result, specific instruments as well as right structure and skilled people to proactively monitor borrowers' performances will be required.

Loans classification

New classification criteria will lead to **3 new classes of loans** associated with bank's business model ("Hold To Collect", "Hold To Collect and Sale", "Held For Trading"). The need to properly classify their exposures will require the bank to review and strategically refine their business model associated to the loans' management:

- On the one hand, for the "portfolio to hold", banks should strenghten the **internal credit monitoring** functions in terms of expertise as well as of renovated tools of credit risk measurement (e.g. KPI, index, advanced CRM solutions)
- On the other hand, for the "portfolio to sell", banks should implement specialised units in charge of the structuring and execution of **loans' sale transactions** (e.g. data preparation and remediation, securitisation)

Impairment methodology

- New impairment criteria, based on the **"expected loss"** and **"forward looking" approach**, will result in certain portions of the current portfolio classified in loans' higher risk categories (e.g. from performing to UtP/bad loans)
- **Higher impairment** (by collective and analytical provisioning) will result through the "forward looking" approach which will move up losses to be incurred over the loans' lifetime
- Need to foresee the **lifetime losses** will require the banks to implement proactive actions to preliminarly assess borrowers' likelihood to pay their debts along with avoiding further danger rate from performing to UtP and bad loans

Non Performing Exposures classifications

How to define and what to include within the "Unlikely to Pay" category.

Non-Performing Exposures

The commonly used term non-performing loans ("NPL") is based on different definitions across Europe.
To overcome problems, EBA has issued a common definition of Non-Performing Exposures ("NPE") which is used for supervisory reporting purposes.

In Italy, banks are also required to distinguish among different classes of NPE: (i) Bad Loans, (ii) Unlikely to Pay and (iii) Past Due; the sum of these 3 categories corresponds to the Non-Performing Exposures referred to in the EBA ITS.

The unlikelihood judgement of UtP

The exposures are classified as Unlikely to Pay in light of the unlikelihood that relevant debtors will fulfil their credit obligations.

The unlikelihood judgement is made by the Bank based on a varied spectrum of signals and issues.

The range of signals and issues may be very wide and differs case by case but a common feature is that each of them is recoverable and/ or is manageable if tackled properly and timely. Time is of essence.

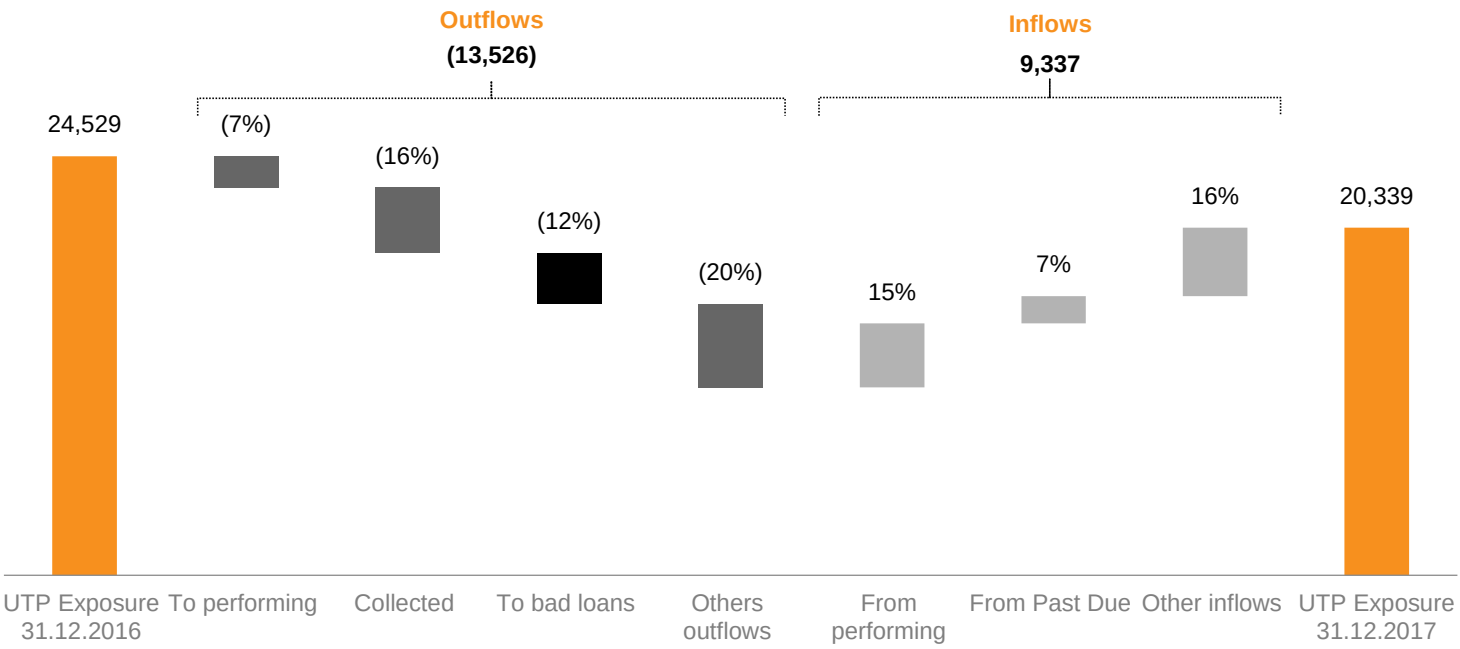
Old	New	Definition of risk category
Past Due *Esposizioni scadute > 90 giorni*	**Past Due more than 90 days loans (debt)** *Esposizioni scadute* **Including FNPE ***	• Exposure to any borrower whose loans are not included in other categories and who, at the date of the balance sheet closure, have Past Due amounts or unauthorized overdrawn positions of more than 90 days. • A sub-segment is now represented by the Forborne Non-Performing Exposures ("FNPE"), credits granted to a counterparty in financial difficulty and which are not classified as Bad Loans and have been subject to the modification of the terms and conditions of the contract or refinancing.
Restructured *Crediti ristrutturati* **Sub standard** *Incagli*	**Unlikely to Pay** *Inadempienze probabili* **Including FNPE ***	• **The classification of loans in this category is the result of the judgment of the bank about the debtors' unlikelihood to fulfil its credit obligations. This category substitutes the old sub- standard loans ("Incagli") and restructured loans ("Crediti Ristrutturati").** • **A sub-segment of the Unlikely to Pay is now represented by the FNPE.**
Bad Loans *Sofferenze*	**Bad Loans** *Sofferenze* **Including FNPE ***	• Exposure to a borrower in a position of insolvency (not necessarily recognised by a Court) or a substantially similar situation, irrespective of the presence of any collateral. Same as previous classification of Bad Loans or "Sofferenze". • A sub-segment of the Bad Loans is now represented by the FNPE. FNPE may become a Forborne Performing Exposure if: • 12 months have passed from last allowance • No past due from last allowance occurred

NPE

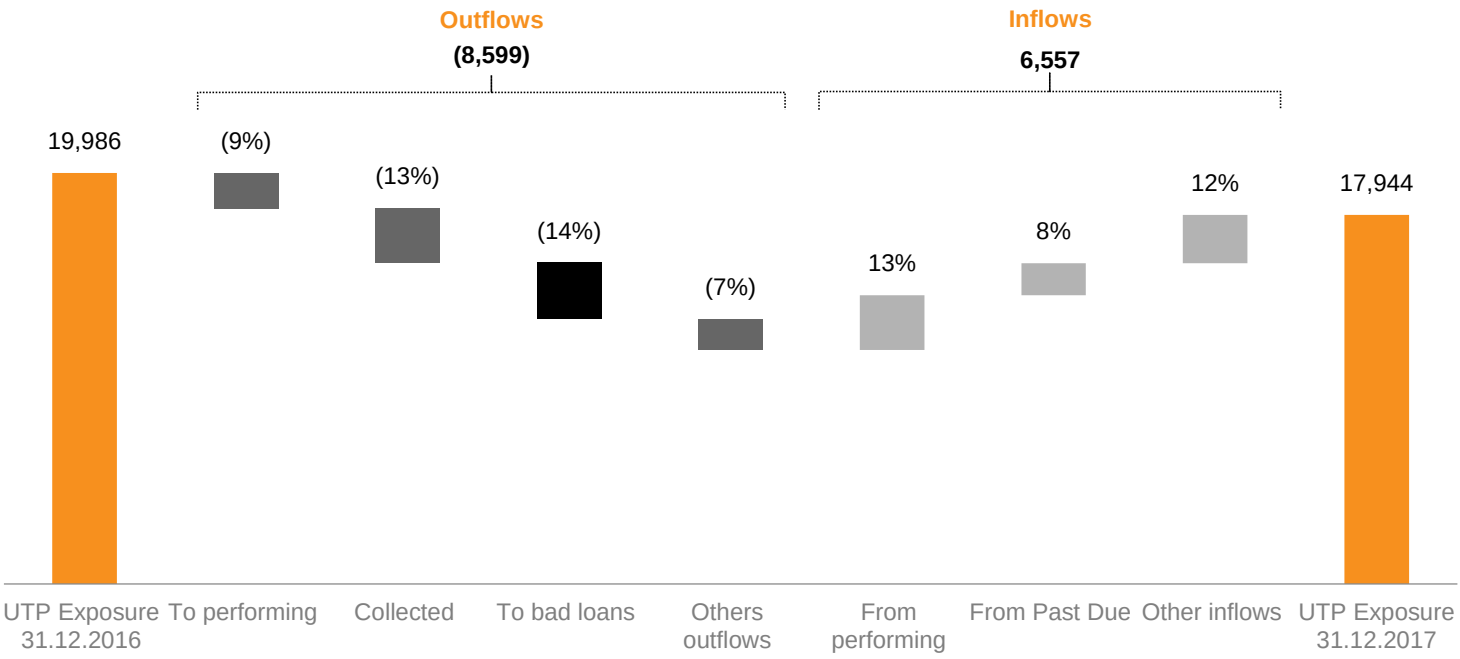
(*)FNPE: Forborne Non-Performing Exposures
Source: EBA, EBA/ITS/2013/03/rev1 24/7/2014

UtP inflows and outflows from 2014 to 2016 – Top 10 Italian banks (€ mln)

Outflows and inflows | Unicredit

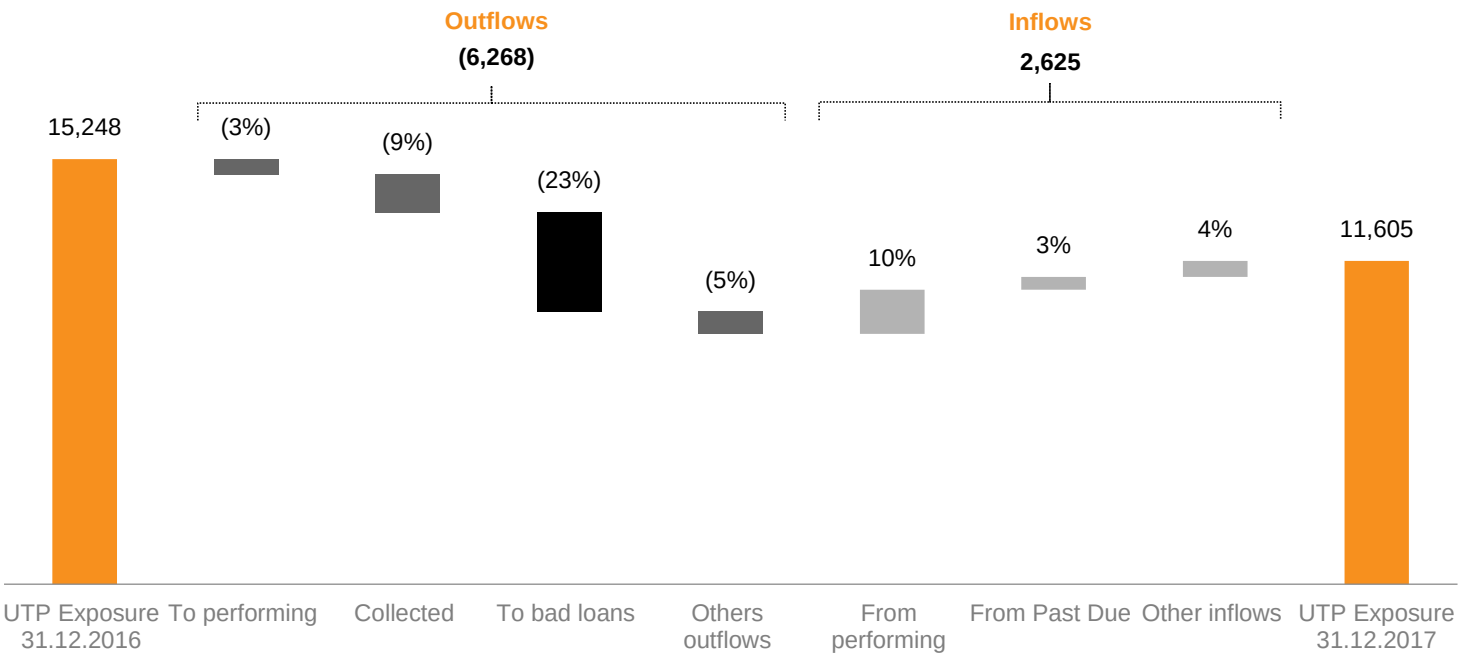


Outflows and inflows | Intesa Sanpaolo

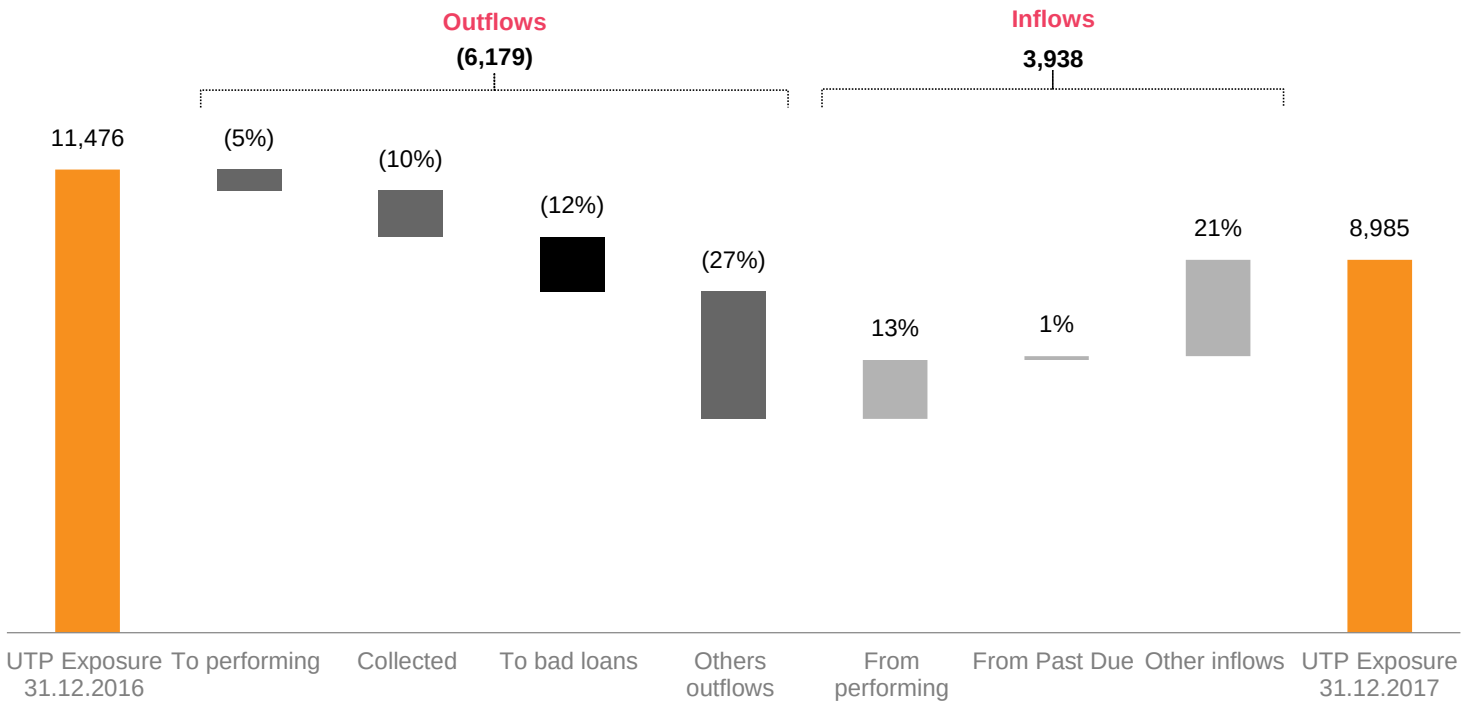


Source: PwC analysis of banks' financial statements as at 31Dec17

Outflows and inflows | MPS



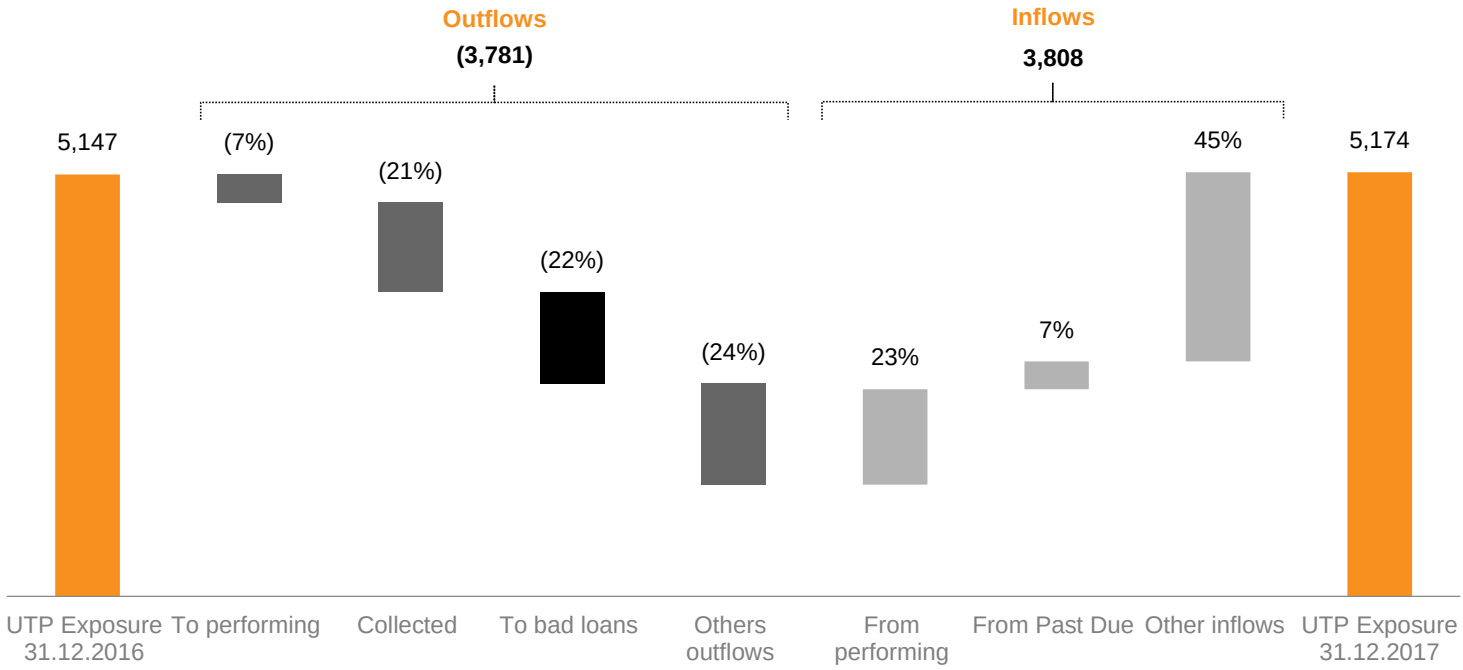
Outflows and inflows | Banco BPM*



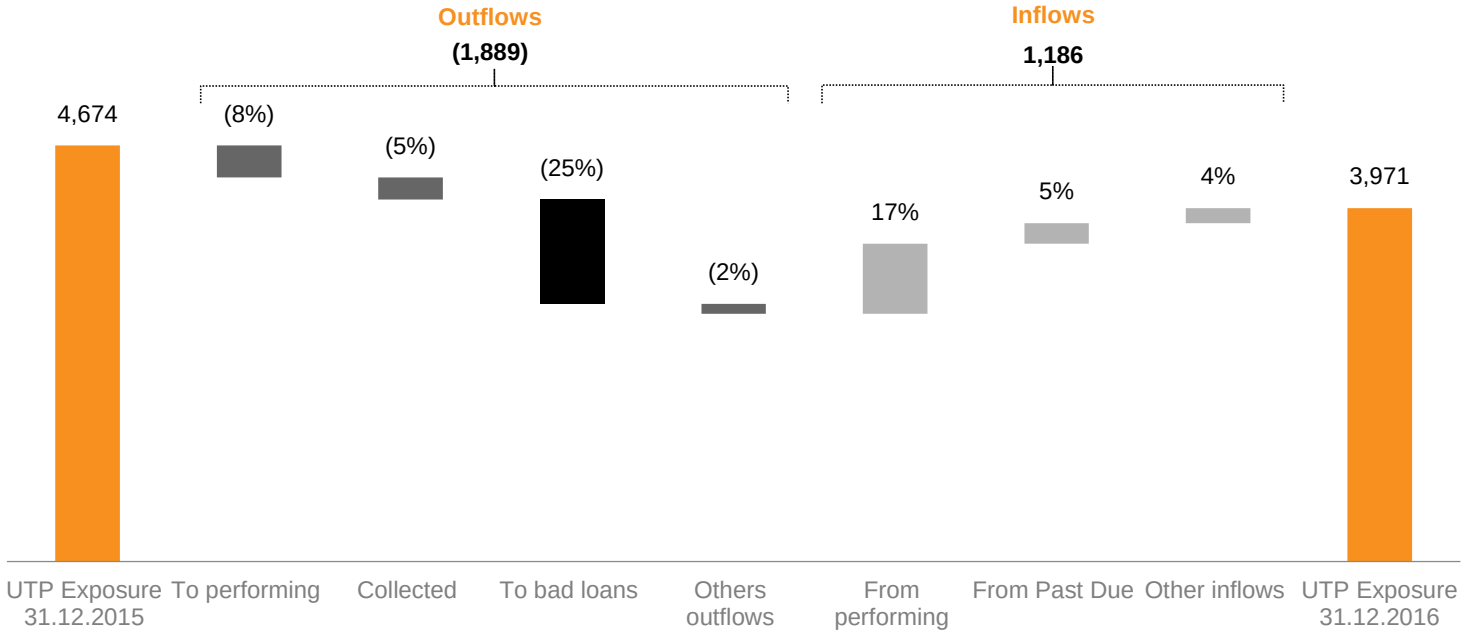
(*) Figures of Banco BPM in FY 2016 were calculated as sum of the figures of Banco Popolare and BPM

Source: PwC analysis of banks' financial statements as at 31Dec17

Outflows and inflows | UBI



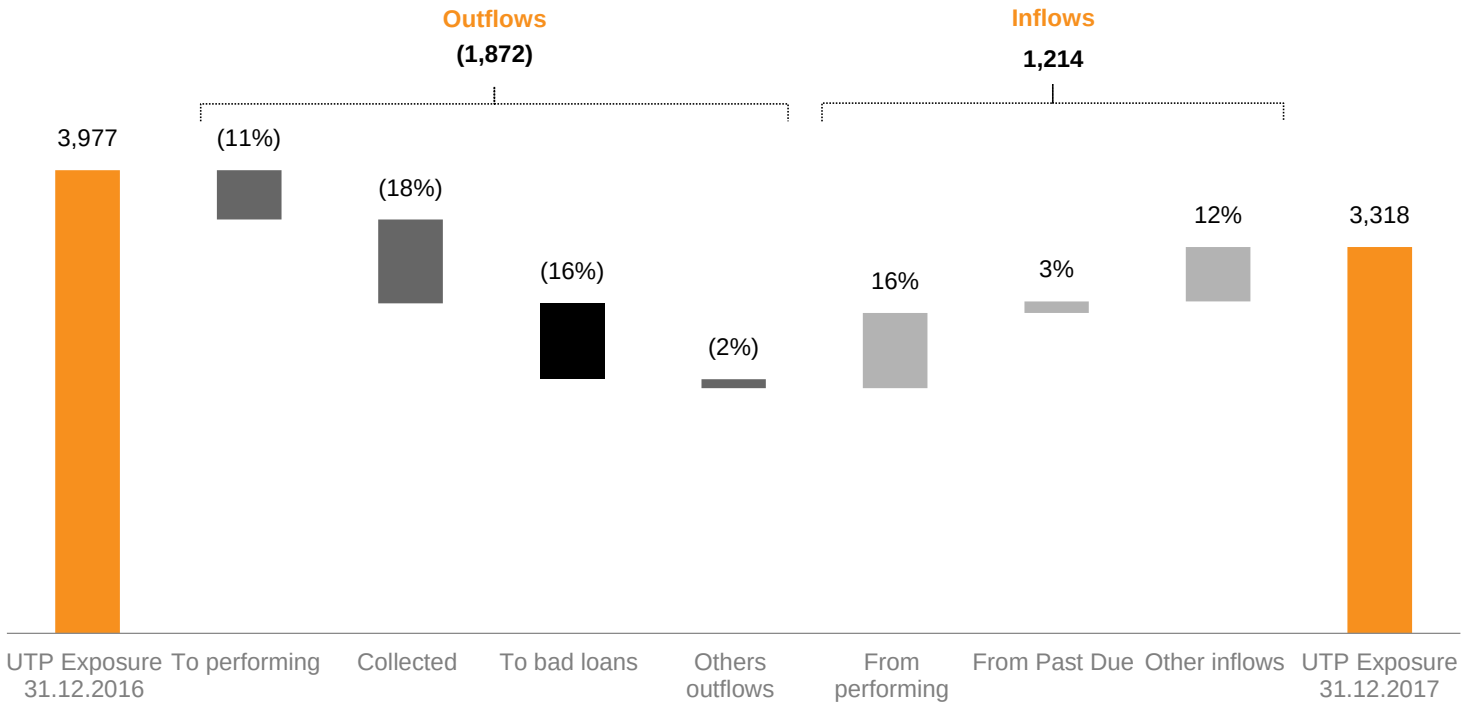
Outflows and inflows | BNL**



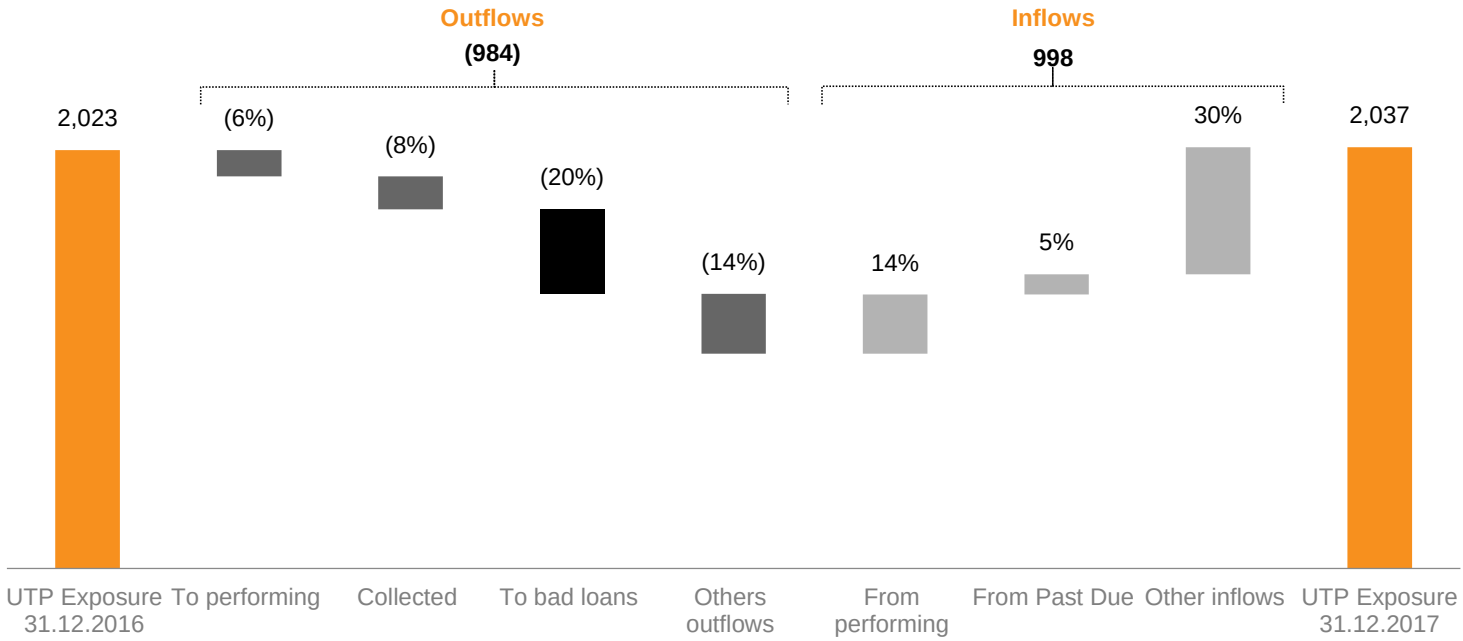
(**) BNL UtP exposure at 31Dec16

Source: PwC analysis of banks' financial statements as at 31Dec17

Outflows and inflows | BPER

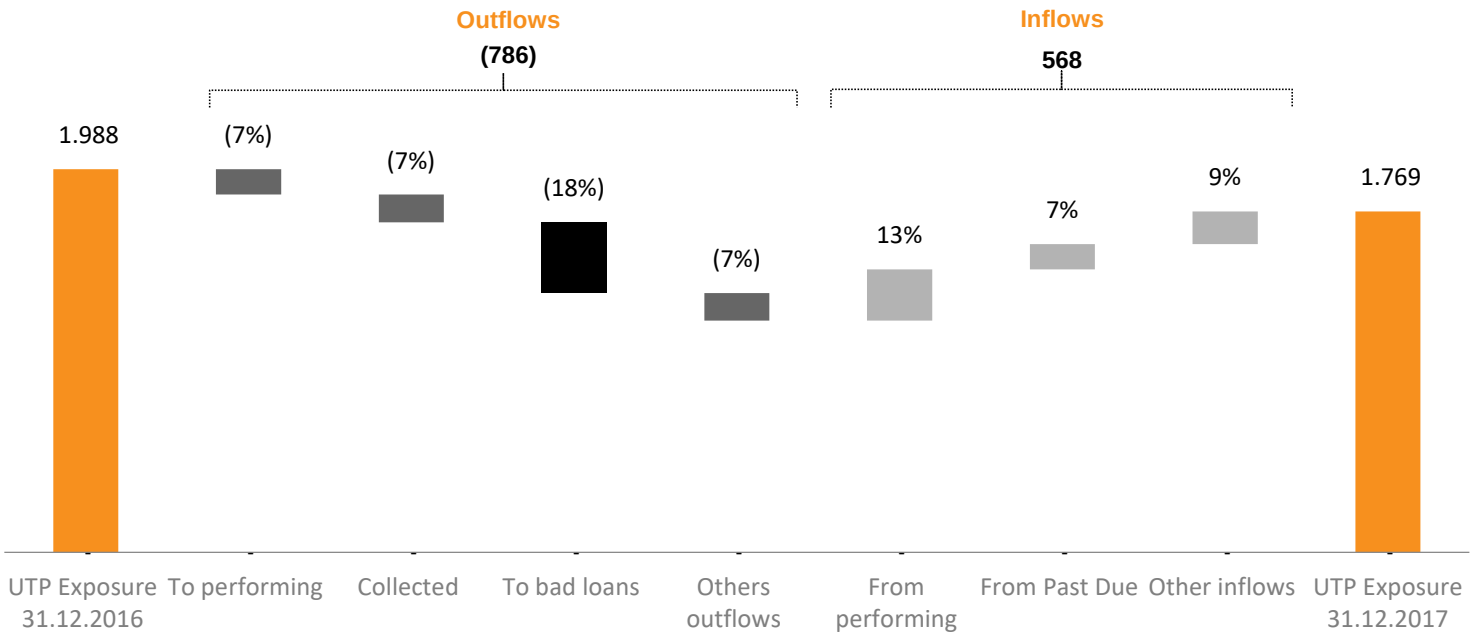


Outflows and inflows | Cariparma

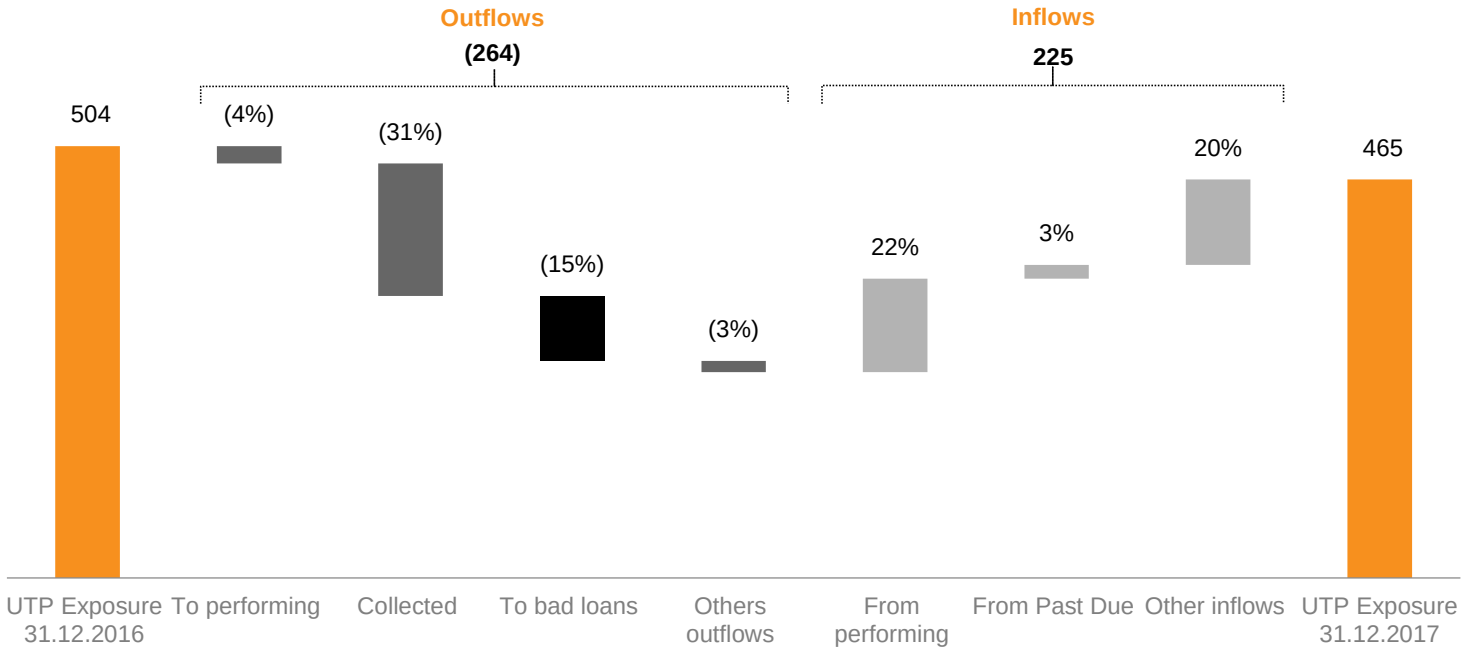


Source: PwC analysis of banks' financial statements as at 31Dec17

Outflows and inflows | Banca Popolare di Sondrio



Outflows and inflows | Credem

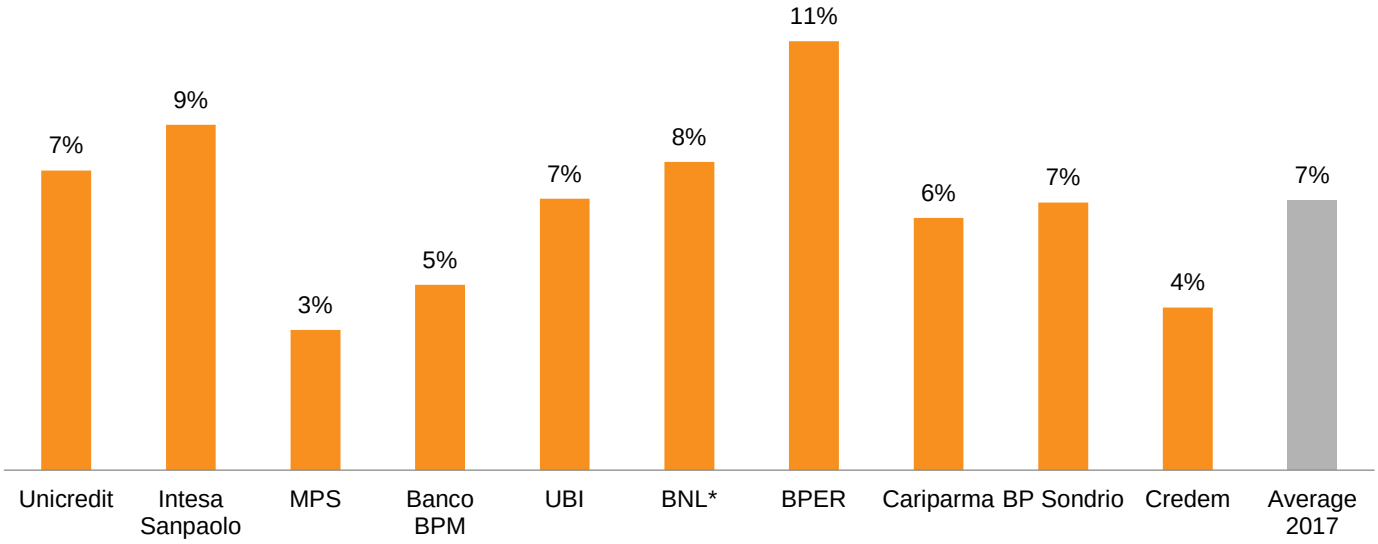


Source: PwC analysis of banks' financial statements as at 31Dec17

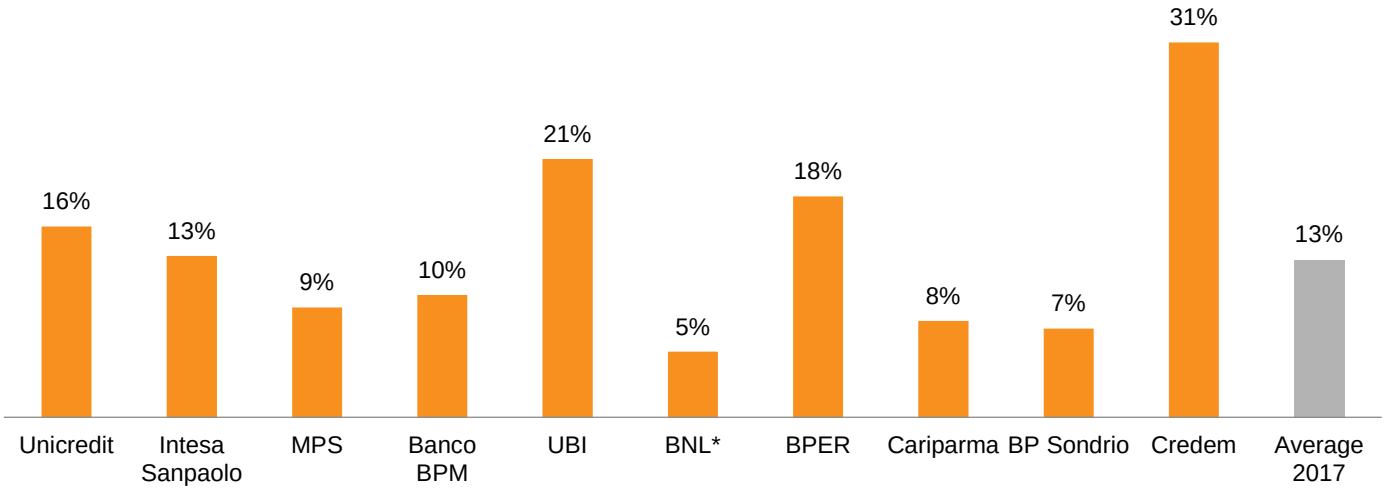
Outflows - Top 10 Italian banks

The average collection rate does not represent a significant indicator for reading the Italian system as it changes significantly from bank to bank.

From UtP to Performing in 2017 *



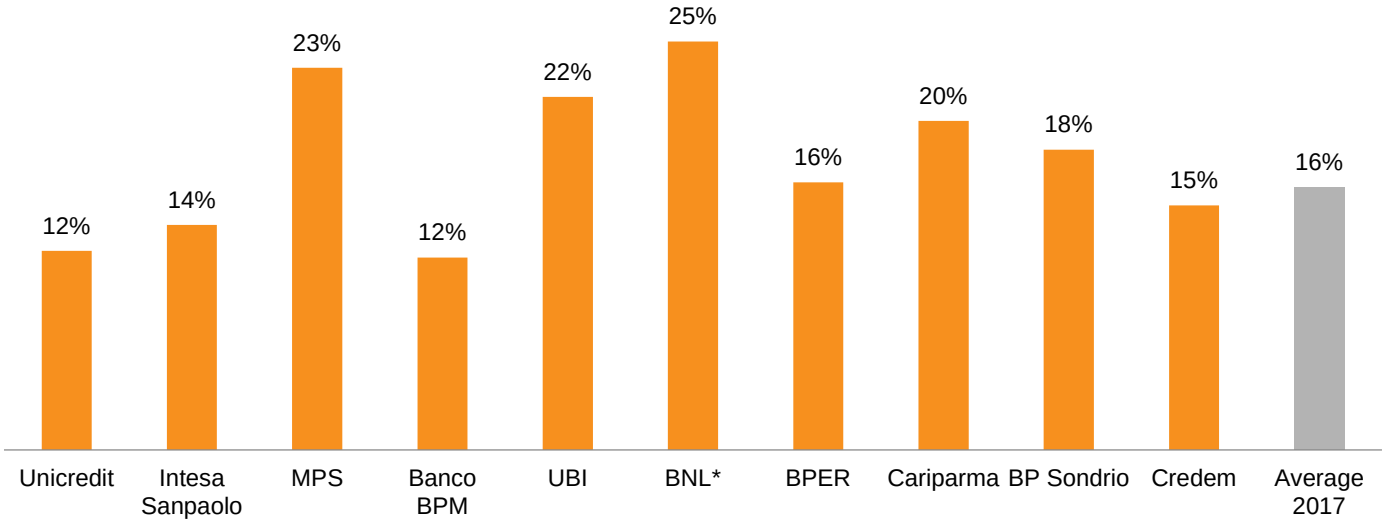
From UtP to Collected in 2017 *



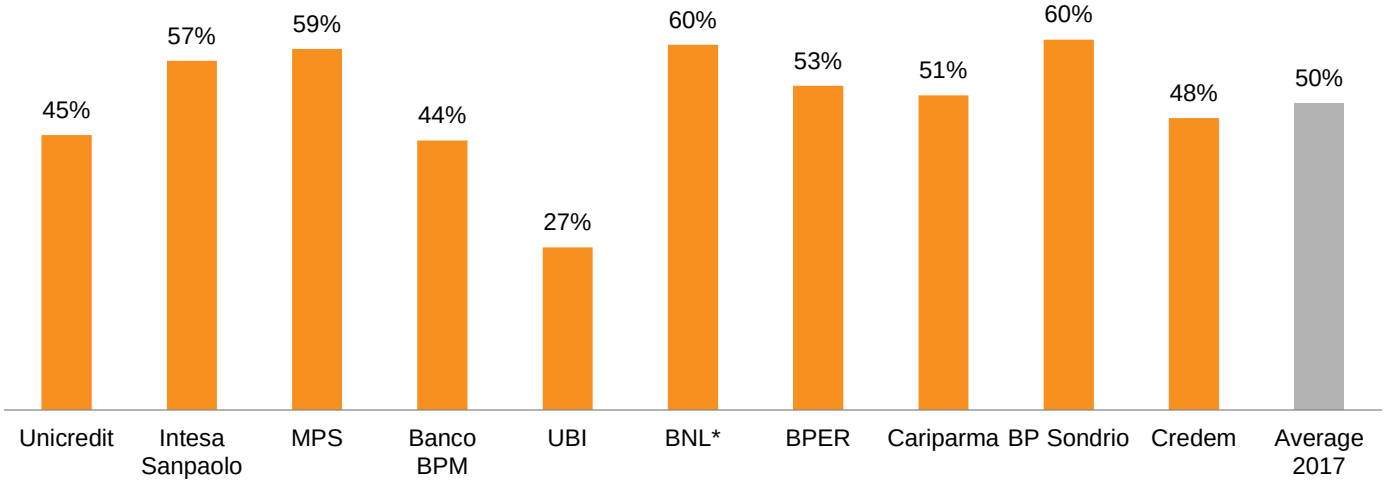
(*) Figures for BNL refer to 2016

Source: PwC analysis of banks' financial statements as at 31Dec17

From UtP to Bad Loans in 2017 *



Remained UtP in 2017 *



(*) Figures for BNL refer to 2016

Source: PwC analysis of banks' financial statements as at 31Dec17

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