



NEWSLETTER NO. 47

NEW INCENTIVE RULES FOR THE UNFREEZING OF BAD LOANS OF THE ITALIAN BANKS – LAW DECREE NO. 18/2016

1. Introduction

After a lot of buzz, the highly anticipated and long expected “*Banks Decree*”, setting forth urgent measures on the reform of cooperative banks, the guarantee for the securitization of non-performing loans (“**NPLs**”) and the tax regime for crisis procedures and collective savings management (“**Decree**”) was passed at cabinet meeting on February 10, 2016 and published on the Official Journal of the Italian Republic on February 15, under no. 18/2016, thereby officially entering into force, at least until the Parliament will put its last word¹.

The Decree was approved on the same day in which the European Commission (“**Commission**”) - the body responsible for State aid control in the European Union - formally gave its green light to the state guarantee scheme chosen by the Italian authorities². Indeed, following months of negotiations, the Commission found the Italian plans aimed at facilitating the transfer of NPLs off the balance sheets of Italian banks to be free of any state aid, provided that the State will be remunerated in line with market conditions.

The Decree is part of a broader framework of legislation targeted to the restructuring and strengthening of the Italian banking system, by making it more shock-resistant and, ultimately, putting credit institutions in the condition to adequately fund the real economy, while complying with increasingly demanding capital requirements³.

Consistent with such purposes, the Decree (i) sets up a state guarantee scheme to ease the offload/securitization of the non-performing loans that impact on the Italian domestic banks’ stability, (ii) provides a new regulation encouraging aggregation of cooperative credit banks to overcome the structural weakness of the current system and (iii) sets forth new favorable provisions on the tax regime for crisis procedures and collective savings management.

The focus of this first outline of the Decree is on the NPLs’ measures only⁴.

1 A law decree (“*Decreto Legge*”) - a temporary legislative enactment having the force of ordinary law adopted by the Government in “extraordinary cases of necessity and urgency” pursuant to Article 77 of the Italian Constitution - loses its effects retroactively, starting from its enactment, in case it is not confirmed by the Parliament within sixty days of its publication.

2 See European Commission Press Release, “*State aid: Commission approves impaired asset management measures for banks in Hungary and Italy*”, IP/16/279, February 10, 2016.

3 Such framework includes (i) law no. 33 of March 24, 2015, reforming credit societies (*banche popolari*); (ii) Legislative Decree no. 180 of November 16, 2015, implementing in Italy the Directive 2014/59/EU establishing frameworks for the recovery and the resolution of credit institutions and investment firms (“**BRRD**”); (iii) Law Decree 181 of November 16, 2015 amending Legislative Decree n. 385 of September 1, 1993 (“**Banking Law**”) and Legislative Decree no. 58 of February 24, 1998 (“**Securities Law**”) and (iv) Law Decree 183 of November 22, 2015 providing measures concerning the resolution of four Italian regional banks (Banca delle Marche S.p.A., Banca Popolare dell’Etruria e del Lazio, Cassa di Risparmio di Ferrara S.p.A., Cassa di Risparmio di Ferrara S.p.A.).

4 Contrary to what originally anticipated by the Government, the Decree does not include the long-promised compensation fund (along with its relevant accessibility criteria) that should have been designed to help small investors in the 4 Banks rescued at the end of 2015 recover part of their



NEWSLETTER NO. 47

NEW INCENTIVE RULES FOR THE UNFREEZING OF BAD LOANS OF THE ITALIAN BANKS – LAW DECREE NO. 18/2016

2. The securitization of non-performing loans

2.1 *The Italian scenario*

Since the onset of the global financial crisis, the aggregate amount of NPLs in Italy increased up to 18,5% (January 2015) of the total loans, from just above 5% in 2007. This rapid rise reflects, in part, the protracted recession which has worsened the creditworthiness of borrowers, particularly small and medium-sized enterprises. At the same time, the inefficient and lengthy judicial process, combined with limited incentives to write off loans, has held back the pace of NPLs resolution⁵.

Therefore, the scheme, drawn up following months of negotiations with the European Union, is designed to ease the offload by Italy's credit institutions of at least a part of their (over) 200 billion Euros of bad loans into asset-backed securities (ABS) for sale, to clean up their balance sheets.

2.2 **The new measures adopted**

- ***Scope of application***

The preeminent innovation brought about by the Decree is the adoption of a new State-backed guarantee (the "**Guarantee**") for securitized NPLs issued within securitization transactions pursuant to Article 1 of Law no. 130 of April 30 1999 ("**Securitization Law**").

The scheme is designed to facilitate the assignment by domestic credit institutions of NPLs to special purpose vehicles ("**SPVs**"), by making the notes incorporating the securitized bad loans more "appealing" through a public guarantee granted by the State. Unless otherwise specified, references to Article(s) herebelow are meant to Article(s) of the Decree.

- ***Special features of the NPLs securitization(s)***

In the framework of the general rules laid down by the Securitization Law, the Decree sets forth the features that the securitization(s) of bad loans shall have in order to benefit from the scheme:

(i) the NPLs shall be assigned to the SPV for an amount not exceeding their balance sheet net value (which is the gross value net of any adjustment/write-off – "*valore al netto delle rettifiche*");

(ii) at least two classes of notes shall be issued based on their degree of subordination in absorbing the losses: the **senior notes**, which is the only class of notes that can be backed by the state guarantee, and the junior notes;

losses: this measure should be contained in an ad hoc ministerial decree to be adopted later this month.

⁵ See, Bank of Italy Financial Stability Report no. 1 of April, 2015, Table 3.1 and International Monetary Fund working paper no. 15/24, *The Strategy for Developing a Market for Nonperforming Loans in Italy*.



NEWSLETTER NO. 47

NEW INCENTIVE RULES FOR THE UNFREEZING OF BAD LOANS OF THE ITALIAN BANKS – LAW DECREE NO. 18/2016

(iii) the **junior notes**, as the most subordinated class of notes, shall not entitle the holder to receive the repayment of the principal as well as the payment of accrued interest or other remuneration until the full repayment of the principal of the senior notes;

(iv) one or more further tranches of notes may be issued in addition to the senior and junior classes (s.c. **mezzanine notes**) entitling the holder to receive the interest payment following payment of the interest due on the senior notes and prior to the repayment of the principal amount of the senior tranche (*Article 4*).

Senior and mezzanine notes shall have the following features: a) a floating rate(s) remuneration; b) the repayment of the principal amount before maturity will depend on the cash flows generated by the recoveries and collections on the portfolio of transferred loans, net of all relevant recovery and collection costs; c) interest will be paid at the end of each interest period on a quarterly, half-yearly or yearly basis depending upon the residual nominal value of the note at the beginning of each interest period.

The remuneration of mezzanine notes may be deferred, linking it to the occurrence of specified events, or can be made conditional upon the achievement of performance targets in the recovery/collection of the transferred loans (*Article 6*).

Junior and mezzanine notes may not be subscribed by the State and other public entities.

Finally, hedging agreements may be executed to reduce the risk of discrepancies between the interest rates applied, respectively, on assets and on liabilities. The use of liquidity credit facilities is also contemplated to cover possible shortfalls of the collections/recoveries in respect of the interest payment amounts due at each payment date, so as to assure a financial flexibility consistent with the merit of credit of the senior notes (*Article 4*).

- **Investment grade and independent servicer**

In order for the Guarantee to be granted, the senior notes shall have previously obtained a rating equal to or higher than the investment grade from an ECB-approved independent rating agency (*Article 5*).

In order to avoid possible conflicts of interest, the servicer appointed to manage the NPLs shall be an entity other than the selling bank and shall not belong to the same banking group.

- **Order of priority of payments**

The **proceeds** generated by (a) the recoveries and the collections made on the portfolio of transferred loans, (b) the hedging agreements executed (if any) and (c) the use of liquidity credit facilities, net of the amounts due to the NPLs servicers as consideration for their activity, will be applied in making payments or provisions in the following order of priority, in each case, only to the extent that payments or provisions of a higher priority have been made in full:

(i) tax charges, if any;



NEWSLETTER NO. 47

NEW INCENTIVE RULES FOR THE UNFREEZING OF BAD LOANS OF THE ITALIAN BANKS – LAW DECREE NO. 18/2016

- (ii) amounts due to services providers,
- (iii) amounts due as interest and commissions in connection with the credit facilities;
- (iv) amounts due as consideration for the Guarantee backing the senior tranche;
- (v) amounts due to the counterparties of the hedging agreements, where executed;
- (vi) amounts due as interest on the senior notes;
- (vii) amounts to be repaid to restore the availability of the credit line, where used;
- (viii) amounts due as interest on the mezzanine notes, where issued;
- (ix) repayment of the principal outstanding amount of the senior notes;
- (x) repayment of the principal outstanding amount of the mezzanine notes;
- (xi) payment of the amounts due as principal, interest (or other remuneration) on the junior notes (*Article 7*).

3. The Guarantee

- **Features**

The Guarantee is an unconditional, irrevocable and first demand guarantee.

It may only be granted to collateralize the senior tranche of the ABS issued and shall become effective solely in the event that more than 50% plus one of the “non-guaranteed and higher risk-bearing” junior notes have been successfully sold to private market participants (*Article 8*).

- **Timeline, validity and access to the Guarantee**

For a period of 18 months since the entry into force of the Decree the Ministry of Economy and Finance (“MEF”) shall be entitled to grant the State’s Guarantee; such period can be extended by the MEF itself for further 18 months and, then, until February 15, 2019.

Within 3 months following the approval of the scheme by the European Commission (*i.e.*, February 10, 2016), the MEF shall appoint an independent and qualified expert in charge for monitoring the compliance of the Guarantee to be granted with the provisions of the Decree and the EC decision approving the scheme (*Article 3*).

The Guarantee shall be issued on a case by case basis, by means of an *ad hoc* decree of the MEF, following the relevant application by the credit institution(s) concerned (*Article 10*).

- **Price**

The Guarantee shall be granted against an yearly consideration; namely, the fee for the Guarantee, to be determined at market conditions, shall be calculated based on three baskets of credit default swaps (CDS) prices of Italian based companies with a rating matching those of the senior notes to be guaranteed⁶. Indeed, such fee shall reflect the level and duration of the risks taken by the State by granting the

⁶ According to Article 9, para. 2 of the Decree, in case the senior notes obtain different ratings from different agencies, the lowest rating granted shall be the reference.



NEWSLETTER NO. 47

NEW INCENTIVE RULES FOR THE UNFREEZING OF BAD LOANS OF THE ITALIAN BANKS – LAW DECREE NO. 18/2016

Guarantee itself and will constantly increase over time in line with the duration of the State's exposure.

The circumstance that the proposed Guarantee will be granted by the State acting as a "private investor", based upon a market benchmark, was decisive in leading the Commission to consider the newly established scheme to be free of any state aid and give its green light to the new legislation⁷.

The relevant ratings and calculation formulae are set forth in Article 9 and in annex 2 to the Decree.

- **Enforcement and financial sources**

The Guarantee holder may enforce it within 9 months following the expiration of the senior notes in case of non-payment, in whole or in part, of the sums due as principal or interest; the enforcement procedure is as follows: in case of non-payment lasting for more than 60 days from the expiration of the due date, the senior noteholders concerned, through the noteholders' representative, shall send a request to the SPV for the payment of the unpaid amounts; after thirty days and no later than six months from the date of receipt of the request by the SPV, absent payment, the senior noteholders, through the noteholders' representative, are entitled to ask for the enforcement of the Guarantee. Within 30 days from receipt of the request for the enforcement of the Guarantee, the MEF will pay to the senior noteholders the unpaid amounts, with no additional interest or costs (*Article 11*).

An ad hoc fund with a financial endowment of Euro 100 million for 2016 has been established by the MEF for the payments related to the (possible) enforcement of the Guarantee, as well as any additional costs connected thereto. The fund shall be further financed by the proceeds of the annual fees paid as consideration for the Guarantee (*Article 12*).

- **Favorable tax regime for crisis procedures**

As a part of the wider purpose underlying the Decree to facilitate the banks in enforcing their collateral (with the indirect effect to improve also the transferability of bad loans and the "marketability" of the relating ABS), the Decree also contains favorable tax provisions applicable in case of crisis/insolvency procedures. In particular, the registration, mortgage and land taxes payable in connection with the transfer of ownership of property in consequence of foreclosures in the context of crisis/insolvency proceedings has been reduced to a fixed rate of Euro 200 (*Article 16*)⁸. This should encourage potential buyers to purchase foreclosed assets, thereby facilitating the lenders/assignees of loans to recover their credits.

⁷ On the contrary, should the State pay above market prices for the non-performing loans or accept lower guarantee fees than a private operator would do, this would constitute "state aid" that, pursuant to EU State aid rules, can only be legitimately implemented if the benefiting bank is put under resolution.

⁸ Italian Government is also starting a wider reform of the regulation of company crisis and insolvency proceedings, aiming at accelerating the lengthy legal process of bankruptcy litigation in an effort to facilitate lenders and creditors recovering, in whole or in part, their outstanding loans as quickly as possible.



NEWSLETTER NO. 47

NEW INCENTIVE RULES FOR THE UNFREEZING OF BAD LOANS OF THE ITALIAN BANKS – LAW DECREE NO. 18/2016

4. Concluding remarks

The outline above provides a summary of the main measures adopted by the Italian Government by means of the Decree of particular significance for banks and financial institutions.

These measures are subject to possible changes by the Italian Parliament⁹, which changes are most welcome as regards certain aspects that require clarification and improvement; however, they are a good starting point in the pursue of the governmental goal to attract a wider range of investors and boost banks' liquidity, thereby having an impact not only on the banking sector, but also on access to credit, which, as known, is one of the main engine that makes an economy run.

February 18, 2016

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⁹ As mentioned above, pursuant to Article 77 of the Italian Constitution the Decree could be amended by the Parliament within sixty days from its publication and could lose its effects retroactively should it not be converted into law.