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## EUROPE

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# The Italian Financial Sector: Recent Regulatory Developments

The Italian Government and Parliament have recently taken further steps as part of their commitment to pass new laws aimed at simplifying and modernizing the general framework of the Italian legal system, particularly in the financial sector, in order to provide greater efficiency with respect to investments made by banks and investment funds.

A common concern among foreign investors in Italy has been a general lack of certainty as to how Italian laws apply to financial operations conducted within the jurisdiction.

Another serious problem has been the lack of certainty and understanding with regard to the legal mechanism for the enforcement of receivables, a problem which is, in large part, due to the complexity of Italian civil procedure and the large amount of litigation resulting from it.

As a result, enforcing a debt in Italy can turn out to be both an expensive and time-consuming activity, discouraging

many investments from being made in the jurisdiction.

One of the most striking reforms to be instituted by the Italian legislature in response to these and other concerns is the Non-Performing Loans Securitization Guarantee (hereafter, the “Guarantee”, or “GACS” – an Italian acronym that stands for “Garanzia Cartolarizzazione Sofferenze”), which was enacted by Decree – Law on February 14, 2016, nr. 18 (hereinafter, the “Decree”), as modified on April 8, 2016.

In Italy, the use of non-performing loans (“NPLs”) has increased dramatically within the last few years, due principally to two factors: (i) the long-lasting economic crisis starting in 2008, the effects of which are ongoing; and (ii) the central role played by banks in the Italian financial system. According to the latest available data, NPLs in Italy are currently equal to more than €200 billion.<sup>1</sup>

<sup>1</sup> See article *NPL, al via la cartolarizzazione “garantita”*, in “Il Sole 24 – Ore”, February 11, 2016.

The purpose of the Decree is to support the development of the Italian market of NPLs by: (i) encouraging the access to market of medium-long period investors; and (ii) reducing the price spread between sellers and buyers of NPLs.

Pursuant to paragraph 3 of the Decree, the Ministry of Finance is entitled, for a period of 18 months from the date the Decree is effective,<sup>2</sup> to grant the State a guarantee for securities issued under the previous securitization law, upon the assignment by Italian banks of NPL portfolios to securitization vehicles, which will issue different tranches of notes in return.

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#### THE STRUCTURE OF THE SECURITIZATION:

Pursuant to paragraph 4 of the Decree:

- (a) an NPL portfolio is assigned to a securitization vehicle for a value not lower than its net book value;
- (b) at least two kinds of securities must be issued: junior securities and senior securities;
- (c) junior securities (being the most risky) cannot be reimbursed for their principal amount, interest or any other form of return until the principal of the more senior classes of security has been reimbursed in full;
- (d) mezzanine securities can also be issued with regard to the payment of interest. Mezzanine securities:
  - (i) are postponed to the payment of interest on senior securities; and
  - (ii) rank senior to the repayment of principal on senior securities; and
  - (iii) can also provide for the entry into derivatives' contracts (typically, interest rate swaps) to hedge interest rate risk.

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#### THE GUARANTEE

The Italian government will guarantee only senior tranches, and only after the securities therein have received a credit

rating of investment grade or higher from at least one rating agency recognized by the European Central Bank on a stand-alone basis.

The Italian banks will be required to appoint external independent servicers to collect the NPL portfolios and carry out loan recovery, to reduce any possible conflicts of interest.

Pursuant to paragraph 8 of the Decree, the state guarantee shall be effective only when a bank assigns, for valuable consideration, at least 50% +1 of the junior securities and, in any case, whenever it assigns a number of junior securities (and mezzanine securities, if any) that allow the securitized loans to be written off and cancelled on the bank's books.

The state guarantee is not mandatory and may be requested by banks in the context of NPL securitizations. It is granted for a consideration at market value and the EU Commission has acknowledged that the Decree is in compliance with State Aids rules.

The Republic of Italy, public bodies and companies directly or indirectly controlled by public bodies cannot purchase junior or mezzanine securities.

The fee for the GACS is payable to the Italian Treasury and calculated based on a basket of credit default swaps ("CDS") issued by Italian companies whose underlying debt instrument is rated by a credit rating agency as being equal to the rating of the senior securities to be guaranteed. The GACS price increases depending on the maturity of the underlying securities.

Pursuant to paragraph 11 of the Decree, in case of default, or in case of part payment, the holder of the GACS is entitled to the enforcement of the Guarantee within nine months after the maturity of the senior security.

Where there is a default of payment continuing for 60 days from maturity of the senior securities, the security holders, acting by their Agent, send the assignee company a formal request for payment.

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<sup>2</sup> This term can be extended by a period of no more than 18 additional months.

After 30 days, and within six months from the receipt of the request of payment, if the assignee company fails to make payment, the Agent is entitled to the enforcement of the Guarantee by filing a petition with the Italian Minister of Finance.

Within 30 days from the date of filing of this petition, the Minister of Finance pays the due amount to the senior securities holders, without any further fees or costs.

In return for making this payment, the Minister of Finance acquires the right of subrogation and is entitled to claim any amount paid, including accrued interest and legal costs.

The reforms enacted by the Decree have been recently clarified by a further decree issued by the Ministry of Finance on August 3, 2016 (the "MF Decree").

In summary, the MF Decree has made the following clarifications:

- (1) Consap S.p.A., a government-owned entity, is the only body entitled to be an independent servicer responsible for collecting the NPL portfolios;
- (2) the securities must be classified as NPL before their assignment to the special securitization vehicle;
- (3) the value of the assigned NPL at the moment of its transfer is to be calculated on the basis of the legal effect of the assignment. This means that every payment received from the moment the credits are valued to the time at which they are assigned is owed to the securitization vehicle;
- (4) for the purposes of the rating process, senior securities will rank senior to "any other class of securities, junior and mezzanine" and the State guarantee can be requested with regard to one or more senior tranches;
- (5) a strict order of seniority of payments is provided for, to ensure that the senior securities are protected/respected and, in turn, to protect the Italian Republic, which issues the State guarantee;
- (6) in the case of a securitization carried out by more than one bank, all the assignors can jointly apply for the State guarantee;
- (7) the State guarantee is null and void in the following cases:
  - (a) in the case of a downgrade of the senior securities; or
  - (b) if any securities are issued in breach of any provisions of the Decree and/or of the MF Decree.

In late August 2016, the first GACS under the Decree was successfully utilized by the Banca Popolare di Bari with respect to (i) the assignment of a €500 million NPLs and (ii) the issue of a senior tranche of securities with a BBB rating (investment grade), granted by a GACS.

The reforms introduced by the Decree have been positively received by national and international markets and have already facilitated the attraction of many investors.

In short, the GACS allows: (i) the Italian banks to clean their books by means of a more efficient and quick credit risk management; and (ii) investors to rely upon securities guaranteed by the Republic of Italy.

Now that Banca Popolare di Bari has led the way with the first GACS, it is predicted that many other GACS could very soon be requested by other major Italian banks, such as Banca Monte dei Paschi di Siena.

In light of the above, it is reasonable to predict that a higher level of NPL securitizations is going to be realized over the next few months in the Italian markets, not least because of the huge amount of NPL still sitting on the books of the Italian banks.

Many opportunities are therefore available to foreign investors, who can now purchase securities relying on a clear and certain procedure enabling the recovery of their receivables, and without the risk of becoming embroiled in costly and uncertain litigation in the Italian courts.

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