

Sudden change to the Usury rules

The Italian Government approved a new set of measures under Law Decree No. 70 dated 13 May 2011, to encourage the development and growth of the economy (so-called "decreto sviluppo"). One of these measures amends the existing legislative framework regulating interest rate restrictions in Italy, by changing the method for calculating the interest rate thresholds. This amendment will result in an overall increase of the usury threshold for mortgage loans but also, to a lesser degree, for other types of lending in Italy, subject to certain upper limits. The amendment introduces additional headroom but does not overcome the issues arising from the interpretation of the existing rules on usury, pursuant to which, the usury thresholds fail to take into account risk factors such as the profile risk of the borrower or the nature of the financing. The change will primarily impact upon mortgage loan transactions which were at risk of exceeding the interest rate threshold determined under the existing rules on usury and the low interest rates in the current market (which are now predicted to increase).

The existing rules

Law No. 108 of 7 March 1996 (the "Usury Law")¹ and its implementing regulations ("Usury Rules") provide for interest rate restrictions which limit the interest (inclusive of all costs and expenses, other than on account of tax, payable in connection with the facility/loan, so-called "All In Cost") which may be imposed by lenders granting a financing to an Italian borrower.

The interest rate threshold was calculated as 150% of certain average interest rates (so-called *Tasso Effettivo Globale Medio* or "TEGM") (the "Usury Threshold"). The TEGM rates are set forth in quarterly decrees issued by the Italian Ministry of Economy and Finance (*Ministero dell'Economia e delle Finanze*) for different types of credit transactions² and are calculated on the basis of reports of the TEGM rates applied by banks and other financial intermediaries in the relevant preceding quarter period for each of the categories of lending transactions relevant for the purposes of the Usury Law.

The reporting requirements are regulated by the "Instructions" ("*Istruzioni per la rilevazione dei tassi effettivi globali medi ai sensi della legge sull'usura*") issued by the Bank of Italy (the Italian Central Bank). The Instructions are of fundamental importance as these set out the guidelines for the reporting of the TEGM rates during any given three month period, on the basis of which the Usury Thresholds are then calculated. The banks and financial intermediaries must look at the Instructions (and the guidelines set out therein) to verify what items must be taken into account and how to calculate the All In Cost to ensure its compliance with the Usury Law.

Key Issues

Amendments to Italian usury rules

New method of calculation of the usury thresholds

"Unresolved" issues

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¹ The Usury Law was approved to stop overcharging of interest.

² The categories of lending transactions are determined annually by the Ministry of Economy and Finance, after consultation with the Bank of Italy

The Usury Threshold, and the compliance of the relevant credit transaction with the Usury Law, must be determined at the time the relevant credit transaction (or relevant amendment) is entered into.

The consequences of a breach of the Usury Law are particularly severe in Italy. In addition to amounting to a criminal offence, a breach renders null and void the undertaking of the borrower to pay interest on the relevant loan or other credit transaction (i.e. the borrower would have no obligation to pay any interest).

How will the new rules impact on the existing Usury Rules?

The new rules approved by the Government deal with the mechanism for calculating the Usury Threshold (amending Article 2 (4) of Law No. 108 of 7 March 1996).

As a result of the amendment to the Usury Law, the Usury Threshold will be set at 125% of the Tasso Effettivo Globale Medio (the "TEGM") applied by Italian banks and other financial intermediaries from time to time for each category of lending transactions, and further increased by a flat rate margin equal to 4 (four) % (prior to the amendment to the Usury Law, the Usury Threshold was simply set at 150 % of the TEGM).

For example:

The TEGM is 4%.

Multiply 4% by 125% = 5%

Add margin of 4% = 5% + 4%

Total Usury Threshold = 9%

In addition, the difference between the TEGM and the Usury Threshold cannot exceed 8 (eight) %. This will be more relevant for those categories of lending transaction with a high TEGM. In the worked example above, 9% (Usury Threshold) minus 4% (TEGM) equals 5%. Therefore the 8% differential is not reached.

The other aspects of the legislation appear to remain unchanged.

When will the new rules enter into force?

The new measures approved by the Government are contained in Legislative Decree No. 70 dated 13 May 2011 (the "Decree"), published in the Italian Official Gazette No. 110 dated 13 May 2011. The Decree is effective from 14 May 2011. The Italian Parliament must convert the Decree with any possible amendments, into law within sixty days from its publication, otherwise the Decree will be deemed ineffective. If it ceases to have effect or is amended, transactions put in place during the period in which the Decree was effective, should nevertheless remain in force.

How will this change impact financing structures in the near future?

The press release issued on 5 May 2011 by ABI (*Associazione Bancaria Italiana*, the Italian Banking Association)³ helps to explain the reasons for the amendment to the Usury Law recently approved by the Government.

³ ABI's Press release (available only in Italian) can be accessed via the following link:
http://www.abi.it/manager?action=show_document&portalId=1&documentId=13146%20

ABI states in the press release the following (summarised from the Italian text): "To bring Italian legislation in line with its European counterparts, the Government abolished certain incongruities affecting the method for calculation of the threshold rate for the purposes of fighting usury. When interest rates were low yet rapidly on the rise, these incongruities resulted in threshold rates that precluded lending to a certain category of customers, since they were exposed to a risk of exploitative interest rates. In Europe, the law fixing the maximum interest rate is sanctioned as a criminal offence only France and Italy. In France, following two changes to the usury law in 2003 and 2005, the scope of application of the law has been restricted to consumers only. In other countries there are limits (thresholds) on interest rates applicable to loans, but they are significantly less stringent in comparison with those applicable in Italy. Over 14 years of implementation of Italian legislation it is generally acknowledged that such legislation is of little effect in the fight against financial crime and at times results in restrictions on "legal" lending and unfair consequences for customers who are unable to get credit in a legal manner and revert to the criminal lenders. In addition, the limited effectiveness of the law and consequent penalisation of customers is aggravated by the current condition of the financial markets and economy in general. In particular, the procedure for calculating threshold rates is particularly inefficient in the current situation of extremely low interest rates."

According to ABI, the change of the method of calculation of the usury rate, was necessary to avoid a credit crunch which was becoming a "real issue", in light of the increase in the funding cost for the banks (which in anticipation of Basel III will be subject to even more stringent capital and liquidity requirements) and the substantial reduction in the interest rates charged on loans and which are now expected to start growing again. The current usury thresholds did not allow banks to lend anymore under the current market conditions.

The change to the Usury Law is welcomed but does not solve many of the issues arising from the interpretation and application of such rules. The new calculation method will introduce significant headroom (when applied to mortgage loan transactions, the usury threshold for these types of transactions will increase from 4.185 % to 7.4875 % (for variable interest rate mortgage loans) and from 7.02 % to 9.85 % (for fixed interest rate mortgage loans). The change however does not deal with the issue of the applicability of such rules to subordinated lending transactions (eg. mezzanine or high-yield leverage financings) with a higher risk-profile. For such types of financing which under normal circumstances fall under the so-called category of "*altri finanziamenti*" (literally "other financings"), the usury thresholds will increase from 16.635 % to 17,8625 % (based on the TEGM rates applicable for the period 1 April-30 June 2011). The impact for these types of financing is not so relevant. This shows that the change was primarily made to solve domestic market issues arising in relation to mortgaged loans, without taking in consideration the different market of these "other financing" and their underlying risk.

Ferdinando Poscio, Senior Associate in the Banking & Finance Department comments: "*The new rules on usury were expressly adopted with the aim to allow banks and financial intermediaries more flexibility to lend to borrowers of a certain risk category at a suitable margin. However, it is unlikely that simply changing the method for calculating the usury thresholds will introduce such flexibility. The amendment was an opportunity that the Government missed to introduce some amendments to the usury rules to deal with the lack of clarity in the application of such rules in respect of sophisticated lending transactions with institutional borrowers.*"

Giuseppe de Palma, Banking & Finance partner adds: "*The aims pursued by the usury rules are widely acknowledged and understood. It is comprehensible that the legislator is reluctant to amend these rules making them more flexible, for example by introducing new types of credit transactions, since there is the fear that the more flexible the rules become, the more easily they could be circumvented. Nonetheless, if we also consider the severe sanctions provided for under the usury rules, it would be useful to have more certainty as to the interpretation of such rules, mainly with respect to those financing transactions which cannot be strictly included among those determined annually by the Ministry of Economy and Finance for the purpose of calculating the average interest rates applied by the banking system and fixing the applicable threshold rate based on such averages.*"

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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