

# Alternative financing sources: EU and Italian "funds" now allowed to engage in direct lending to Italian businesses.

On 16 February 2016, a set of Italian Government measures became effective following the publication of the long awaited Law Decree no. 18 of 14 February 2016 (the "**Decree**"). In particular these measures cover the disposal of non-performing loans by Italian banks (on which see our Briefing Note "*Public State guarantee to secure securitisations of non-performing loan receivables: the Italian "bad bank" solution?*"), and provide new rules outlining for the first time the ability of Italian alternative investment funds (**AIFs**) and EU AIFs, subject to certain conditions, to engage in direct lending in Italy.

It has been hailed as a real breakthrough, which could potentially open up the Italian direct lending market through credit funds.

Lending has been historically a restricted activity in Italy, traditionally reserved to banks and certain other financial intermediaries. Over the past two years, the Italian Government enacted certain measures aimed at extending the range of authorized lenders. Previous measures such as the 2014 "*Decreto Competitività*" have permitted Italian insurance companies and securitization vehicles to lend directly to businesses, subject to certain restrictions.

Under the "*Decreto Competitività*", the definition of 'investment fund' in the Consolidated Financial Act (*Testo Unico della Finanza*) was amended to capture funds investing in credits. These amendments however left doubts as to whether direct lending by funds in the primary market was possible in the absence of any reference to those funds in the list of authorised lenders under Article 106 of the Italian Banking Act (*Testo Unico Bancario*).

The Decree has now introduced a new chapter in the Consolidated Financial Act (*Testo Unico della Finanza*), dealing with credit funds. While funds are still not formally listed under Article 106 of the Italian Banking Act, the

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new provisions are much clearer in confirming that, subject to certain conditions, Italian and EU 'alternative investment funds' (so called '**AIFs**') – insofar as they are managed by a management company based and authorized in a member State within the EU in accordance with the AIFMD directive - can indeed engage in lending activities in Italy, including in the primary market, if lending is not targeted to "consumers" (i.e. to an individual who is acting outside the scope of an economic activity).

In principle 'AIFs' would include hedge funds, private equity funds, real estate funds, other collective investment schemes established within the European Union and managed by a EU management company, with the exclusion of funds investing in transferable securities in accordance with the UCITS Directive.

Different Articles of the Decree deal with Italian AIFs and EU AIFs.

### **Lending by Italian AIFs**

Italian AIFs can invest in loans to non-consumers "by using the fund's resources".

Despite this, the language is somewhat ambiguous. The use of the word 'invest' in loans may have suggested that the reference was still to the 'purchase' of loans on the secondary market, rather than to direct lending on the primary market. It appears that, also based on the headings of the relevant Articles of the Decree ("*Direct extension of credit by Italian AIFs*" (Article 46 *bis*) and "*Direct extension of credit by EU AIFs in Italy*" (Article 46 *ter*)), the intention is to allow direct lending outright.

The Treasury and the Bank of Italy shall lay down the detailed rules to be applied to Italian AIFs engaging in direct lending. Italian AIFs engaging in direct lending shall adhere to the Italian risk database held by the Bank of Italy (*Centrale dei Rischi*).

### **Lending by EU AIFs**

AIFs established in an EU member state (other than Italy) can invest in loans to non-consumers "by using the fund's resources" (which we understand as a reference to direct lending, as discussed above) subject to the following conditions being met:

- (i) The EU AIF is authorized to engage in direct lending in its home member state;
- (ii) The EU AIF is a closed-end fund and the relevant rules are comparable to that of an Italian AIF, especially in terms of how to participate in the fund;
- (iii) The rules governing risk mitigation and diversification to which the EU AIF is subject in its home member state – including on leverage - are comparable to those applicable to Italian AIFs. It is sufficient for such rules to be specified in the EU AIF's constitutional documents, as long as the competent authority in the home member state ensures compliance with the same.

In terms of risk mitigation and diversification and by reference to AIFs which are 'reserved AIFs' (i.e. reserved for subscription to qualifying investors<sup>1</sup>), the rules applicable to Italian AIFs (which would have to be complied with also by an EU AIF intending to extend financing into Italy) are the following:

- The AIF must ensure "diversification of investments consistent with the objective of optimising the portfolio";
  - Leverage can be maximum 1.5 (calculated under AIFMD) and the AIF shall only take financing from banks, financial intermediaries and other entities licensed to extend financing;
  - The loans extended shall have a maturity consistent with, and no longer than, that of the AIF;
  - Loans held by the AIF extended to the same borrower shall not exceed 10% of the AIF's total assets. This limit shall have to be complied with within 6 months of the start of the AIF.
- (iv) The manager of the EU AIF shall notify the Bank of Italy of its intention to engage in direct lending in Italy beforehand. The Bank of Italy has the power to veto such direct lending within 60 days of receiving such notice.

The Bank of Italy shall lay down the detailed rules – consistent with the above principles - to be applied to EU AIFs engaging in direct lending in Italy. As part of these, the Bank of Italy may also require EU AIFs to adhere to the *Centrale dei Rischi*, which they may do through licensed banks or financial intermediaries (as noted above, for Italian AIFs adherence to the *Centrale dei Rischi* is mandatory by law).

Both Italian AIFs and EU AIFs engaging in direct lending will be subject to informative supervision, and will be required to comply with the Italian conduct of business rules governing transparency of contractual terms and client relationships.

### **Tax regime to Italian EU AIFs direct Lending**

The Decree finally removes the main regulatory hurdles to the lending to Italian borrowers by investment funds of the type described above, thus moving forward the reform initiated in 2014 through the "*Decreto Competitività*". Back in 2014, the reform removed the withholding tax on interest on medium-long term financing paid to EU established banks and insurance companies and white listed "institutional investors", which includes AIFs. Following the Decree, FIAs that meet the requirements set out in the Decree will now be allowed to lend directly to Italian borrowers benefitting as well of the exemption from interest withholding tax introduced in 2014 ([see Client briefing](#)).

### **Can CDO's, CLO's and other investors now take part to direct financing?**

The real question is to what extent the Decree has effectively removed the pre-existing Italian licensing restrictions preventing non-authorized financial investors (such as CDO's, CLO's) from taking part in Italian lending transactions directly. For these investors who are typically not managed in Italy nor in the EU or qualifying as Italian AIFs or EU AIFs, the Italian regulatory restrictions will still apply. The Decree is an attempt

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<sup>1</sup> For non-reserved (retail) EU AIFs the applicable rules would be much more detailed, but we believe that most EU AIFs interested in engaging in direct lending in Italy will be 'reserved AIFs'

by the Italian government to foster investor interests in the market. It is still subject to a case by case assessment of the requirements set out in the Decree and the forthcoming implementing regulations. The Decree has broadened lending opportunities in Italy and has aligned Italian rules to other EU legislation. It cannot however be considered a full liberalisation of direct lending. Other jurisdictions, UK and Spain for example, remain more liberal. In particular, with leverage finance transactions, it is still unlikely that the reform would effectively apply for CDO's, CLO's and other investors of this nature seeking lending opportunities in Italy. It remains to be seen whether transparent fronted structures, securitisation or bonds are an unvaried option for mezzanine/second lien investors to provide debt to Italian businesses.

Please [click here](#) to read the Decree (published on the Italian Official Gazette number 37 of 15 February 2016).

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This publication 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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