

# Public State guarantee to secure securitisations of non-performing loan receivables: the Italian "bad bank" solution?

On 16 February 2016, a set of measures presented by the Italian Government entered into force following the publication of the long awaited Law Decree no. 18 of 14 February 2016 (the "**Banks' Law Decree**")<sup>1</sup> aimed at fostering the disposal by Italian banks of their portfolios of non-performing loans accumulated during the recession period. Although the new measures are nothing like the bad bank structures introduced in some other European countries over the past few years, they represent a significant (and apparently the only possible) step to allow Italian banks to reduce their exposures and clean up their balance sheets, with a view to enhancing the economic growth.

Going in the same direction are also the measures aimed at allowing non banking institutions, and in particular Italian and EU 'alternative investment funds' (**AIFs**), to grant financings to Italian companies, on certain conditions (for a more detailed description of these rules, see our Briefing Note "*Alternative financings sources: EU and Italian Funds now allowed to engage in direct lending to Italian businesses*").

In addition, the Italian Government has issued a bill of law to be discussed and approved by the Italian parliament, providing new features to speed up the judicial enforcement procedures and to reform the Italian insolvency regime.

The Banks' Law Decree includes also special tax provisions to ease the judicial sale of properties subject to enforcement proceedings, by setting a flat tax of €200 due on account of mortgage, land-registry and stamp taxes (as opposed to a 9% ordinary tax) on the condition that the purchaser re-sells the property within the following 2 years. This measure is expected to incentivise significantly the pro-active participation of the

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<sup>1</sup> Official Gazette of the Italian Republic, number 37 of 15 February 2016.

investors to the public judicial auctions and the consequent realisation of the enforced claims, with the 'side effect' of speeding up the enforcement procedures.

The Banks' Law Decree is effective as of 16 February 2016 and will have to be converted into law by the Italian Parliament within 60 (sixty) days, confirming or amending the original text adopted by the Italian Government. Starting from the date of conversion into law, the Italian Ministry of Finance ("**MEF**") will have a further 60 day term to issue additional guidelines and implementing rules.

### The Italian State guarantee (GACS - *Garanzia Cartolarizzazione Sofferenze*)

The main innovative aspect of the set of measures enacted by the Italian Government consists of a guarantee mechanism (the "**Guarantee**") to facilitate the disposal of non-performing loan portfolios ("**NPLs**") by Italian banks.

According to the Banks' Law Decree, for a period of 18 months starting from the date the Banks' Law Decree enters into force, upon request of the relevant banks, the MEF, or another state owned company designated by the MEF, may grant the relevant Guarantees by decree, securing the senior tranche of the asset backed securities (the "**Senior Notes**") issued in the context of securitisations carried out by banks incorporated in Italy (the "**Bank(s)**") and backed by portfolios of non performing receivables (including leasing receivables), governed by Italian law no. 130 of 1999 ("**Law 130**"). The term for the issuance of the Guarantees could be extended for up to an additional maximum period of 18 months, subject to the prior approval of the European Commission.

The Banks' Law Decree clarifies that the MEF, or such other state owned guarantor designated by the MEF, would issue a first demand unconditional and irrevocable Guarantee for the life of the transaction and for the benefit of the holders of the Senior Notes, to secure principal and interest payments under the Senior Notes due pursuant to the securitisation contractual framework.

The Guarantee would secure only the Senior Notes, on the condition that the relevant Bank holds only the minority of the junior notes (*i.e.* less than 50% *minus* 1) and, in any case, an amount of junior notes which would enable the Bank to achieve a balance-sheet deconsolidation of the securitised NPL portfolios. The issue of the Guarantee will be subject to the payment of a fee, calculated as a yearly percentage of the amount guaranteed on the basis of single name credit default swaps (CDS) related to a basket of Italian issuers with a risk level equal to that of the guaranteed Senior Notes and set out in the Banks' Law Decree; if more than one rating is assigned to the Senior Notes, the reference rating to calculate the price will be the lower rating assigned.

The price of the Guarantee is to increase in time to cover the higher risk associated with longer duration of the notes issued under the securitisation and to incentivise an early recovery of the credit claims.

The Guarantee can be enforced by the holders of the Senior Notes no later than 9 months after the Senior Notes are due, provided that the non-payment (in full or in part) is continuing for at least 60 days. The Banks' Law Decree sets out a detailed procedure for the enforcement of the Guarantee.

### The NPL securitisation

The Banks' Law Decree confirms that NPL portfolios do benefit from the segregation effects already offered by Law 130, provided that:

- the NPL portfolios are transferred to the Italian special purpose vehicles ("**SPVs**") for an amount not exceeding their net book value
- the transaction provides the issuance of at least two classes of notes, i.e. the Senior Notes and the junior notes (the "**Junior Notes**") that will be fully subordinated in the repayment of both principal and interest to the Senior Notes
- the issue of one or more classes of mezzanine notes (the "**Mezzanine Notes**") is permitted provided that the related interest payments are subordinated to interest due on the Senior Notes
- the SPV can enter into hedging arrangements on market standard terms
- a credit facility (the "**Credit Facility**") can also be granted to the SPVs, to mitigate the risks relating to a shortfall in transaction cash-flows and recoveries made under the NPL portfolio
- the servicing of the securitised NPL portfolio must be carried out by an independent specialised intermediary not part of the group of the relevant Bank (the "**NPL Servicer**").

### Rating provisions

In order to benefit from the Guarantee, the Senior Notes will need to be rated. The rating must be at least investment grade or higher for the life of the transaction and must be assessed by an external credit assignment institution (ECAI) accepted by the Euro-system or by a rating agency proposed by the relevant Bank and approved by the MEF. The rating can be as well privately assigned for the benefit of the MEF only. Any substitution of the NPL Servicer must be carried out in a way that will not prejudice the rating of the Senior Notes.

### Features of the notes - priority of payments

The Senior Notes (and the Mezzanine Notes, if any) issued in the context of the NPL securitisation will need to satisfy certain characteristics:

- they will have to be floating rate notes
- early redemption of principal will exclusively depend on the cash flows deriving from the recoveries and collections made under the NPL portfolio assigned to the SPV, net of any recovery and servicing costs
- the interest payment dates will fall quarterly, semi-annually or yearly
- a deferred remuneration of the Mezzanine Notes will be permitted by reference to the performance of the portfolio or the recoveries and collections.

The Banks' Law Decree predetermines the priority of payments to be applied to the notes, where usual senior costs, expenses and fees due to the NPL Servicer and other agents are followed by the payment of interest due on the Credit Facility (if any), fees due under the Guarantee and any hedging payments, and interests on the Senior Notes rank in priority to other interest payments under the Mezzanine Notes, and principal payments on the Senior Notes rank prior to any other payment on the Mezzanine Notes and/or Junior Notes.

### Initial reactions

The Banks' Law Decree provides an innovative tool focused on the use of the Guarantee, for the purpose of facilitating the funding transactions involving NPL receivables. This evidences the efforts of the Italian legislator

towards the implementation of dynamic measures aimed at strengthening the banking sector, but which are also in line with the standards expected by the European framework and within the limits thereof.

Players in the Italian securitisation market have outlined that the Banks' Law Decree incentivizes banks to offload their loans and provides terms that are based on offering possible attractive spreads on the Senior Notes, which will help drawing the attention of investors to the Italian capital markets. Certain rating agencies have already stressed that the new Italian Guarantee scheme should provide Italian banks with an additional tool to deal with problematic assets, reducing the high levels of NPLs concentration in their balance sheets in the medium term.

Pending the conversion into law of the Bank's Law Decree and, possibly, the issuance of the MEF implementing regulations, a question mark remains as to the actual effect of such measures, considering that nothing has been (nor could have been...) set out as to the value at which such portfolios are to be transferred to the SPV, other than by reference to the net book value, which could, in certain circumstances, be still too high to encounter the appetite of investors and in particular of those investing in the Junior Notes. The lengthy recovery procedures in the Italian jurisdiction remind us that an actual change of the Italian insolvency and enforcement procedures - the object of the envisaged bill of law - will be more than welcome.

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