18.3 Italian NPL Market

Andrea Pinto,

Partner, K&L Gates LLP

Marco Mazzola,

Trainee, K&L Gates LLP

18.3.1 Introduction

This Chapter, through a legal analysis of the new legislation changes that recently occurred in Italy and the main enforcement procedures and best practices seen in the Italian Market as utilised by international lenders, aims at providing a high level overview of the Italian NPL Market.

Since the occurrence of the GFC, resulting in the worsening of the creditworthiness of the borrowers (in particular the small and medium-sized enterprises), the Italian NPL global change initial case market after NPL has grown to more than €350 billion in 2016 (tripling since 2007).

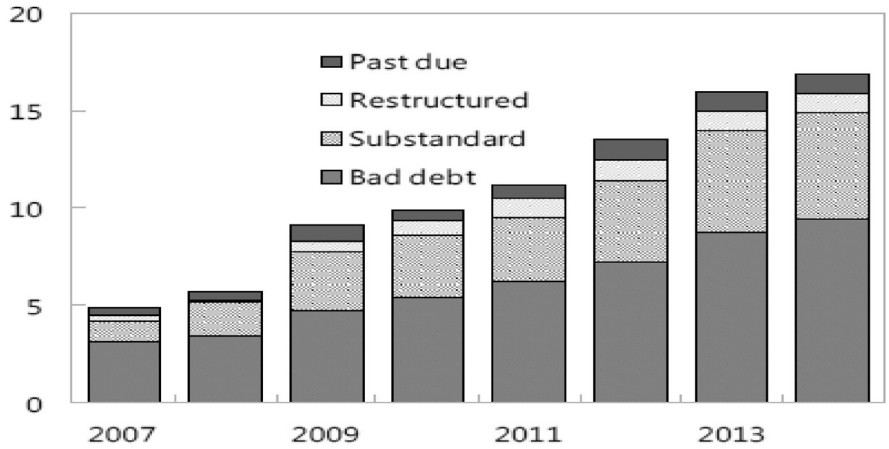
In the economic context witnessed in mid-July 2016 following the Brexit referendum, the Italian banks—active on the market—have been forced to successfully manage the majority of their non-performing real estate loan portfolios through rescheduling or restructuring transactions. As a result of falling share values, increasing capital requirements and new legislation, Italian banks have also started to consider selling their NPL portfolios to specialised investors (potentially real estate investment funds).

In light of the above, this Chapter presents a high level overview of the Italian NPL Market, with a particular focus on the new legislation changes which might ensure an active market for the NPLs in Italy, together with the possibility to play a more active role for Italian banks in supporting new lending transactions.

18.3.2 Overview of the Italian NPL Market

One of the main reasons behind the accumulation of NPLs in Italy is essentially connected with the increase in the companies' defaults resulting from the GFC, together with the slowness of the recovery and repossessing procedures that made it even more difficult to dispose of NPLs, especially the category of the worst of the NPLs, the so-called ''*sofferenze*'' or ''bad debt'' (see Figure 1).

Figure 1. Nonperforming Loans



Source: IMF Financial Soundness Indicators: European Central Bank (ECB)

In particular, the Bank of Italy defines ''*sofferenze*'' as those receivables, the collection of which is not certain by the lenders, because the borrowers are in a state of insolvency (even if a declaration of insolvency has not been issued by a court) or in similar situations.

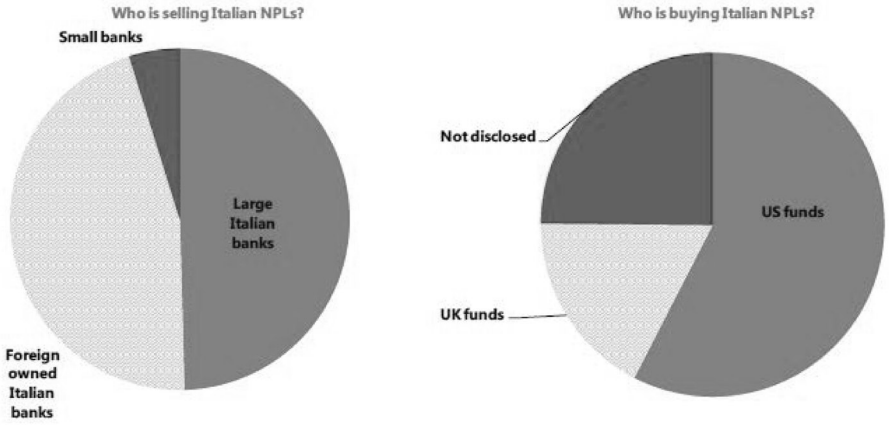
The basis for such a designation is principally to ensure that the relevant borrower can carry out a restructuring or rescheduling transaction, rather than immediately sell their NPL portfolios to specialised investors. In such a context, the primary pre-condition—requested by the Italian banks—for a debt restructuring, is a cooperative behaviour of the management and of the sponsor of the borrower, so that the Italian banks can also take into consideration the business model and the quality of the asset as criteria necessary to potentially obtain a credit committee's approval of the proposed restructuring transaction. In addition, the Italian bank credit committees may request the availability of additional equity together with the opportunity to increase the bank's margins.

Although the deterioration rates are, at the time of writing, gradually stabilising, the overall amount of the NPLs' exposure in Italy is very significant, such that the process of selling NPLs is a crucial strategy of deleveraging which must occur in Italy. In fact, faced with the falling value of Italian bank shares post Brexit, the Italian banks have been requested to adjust their regulatory capital, so that the disposals of non-core assets are becoming more strategic to limit the use of capital increases.

In this respect, it should be recalled that one of the most important factors that has prevented the NPL sales market not taking off during or post the

GFC, is because of the so called ''spread bid/ask'' which is driven by the wide difference between the price at which banks would sell NPLs and the price at which the trade operators are willing to buy NPLs (see Figure 2).

Figure 2: Who buys and sells Italian NPLs?



Source: PwC (2013)

In light of the above, in certain instances, some banks are independently creating models for in-house management of the assets which has been granted as security for CRE problematic loans, providing for—for example—the setting up of ad hoc vehicles in which real estate non-core assets and NPLs may be transferred. The purpose is to manage, enhance and then divest the shareholdings in real estate companies lightening the total amount of impaired loans and thus freeing capital available for new investments.

In other instances, certain management companies are promoting the creation of a real estate reserved alternative investment fund, investing, indirectly, in NPLs secured by real estate collateral through the subscription of notes issued by SPVs, such investment may also include a direct investment in such loans and real estate properties.

Furthermore, as occurs in other countries, it may be useful for the Italian banks, in order to reduce their NPL stock, to work more closely with foreign investors, in order to directly purchase NPLs portfolios, or work with banks for the purpose of the restructuring of distressed borrowers. In fact, at the time of writing, the interest in the NPL market is growing in Italy, so much so, that two of the largest Italian banks, UniCredit S.p.A. and Intesa Sanpaolo S.p.A., are considering a partnership with outside investors in order to setting up SPVs to manage a portion of their NPLs.

In order to encourage the purchase of NPLs, the Italian government has introduced, in the context of wider reform that is intended to be implemented, Law no. 49 dated 8 April 2016, which is a new guarantee scheme for the securitisation of NPLs (*Garanzia sulla Cartolarizzazione delle Sofferenze* or GACS) which seeks to increase the liquidity in the NPL market, by facilitating leverage on portfolio sales.

The abovementioned scheme will be effective until 16 August 2017. The Ministry of Economic and Finance may extend such term for another 18-months period, subject to the prior approval of the European Commission. In particular, the Italian government's intervention is limited to the coverage of the timely interests payment and the principal payment obligation on the senior tranches of asset-backed notes issued by Italian SPVs, which are backed by NPLs assets serviced by external servicers, independent from the originating bank.

The GACS is granted pursuant to a decree issued by the Ministry of Economic and Finance, upon request of the originating bank, which shall annually pay a guarantee fee applied out of the securitisation waterfall. In case the GACS is called, it shall refer to the outstanding amount on the senior notes at the respective final maturity date. So, the GACS is payable at first demand, in respect of amounts which are past due for at least 60 days, and the relevant payment shall be made between four and nine months, starting from the date on which a payment request notice has been sent by the representative of noteholders to the securitisation SPV. Once the payment has been made by the Italian State, the latter is subrogated in the rights of the senior holders of the notes.

18.3.3 New legislation changes: how the Banking Monopoly Rules and alternative sources of lending can co-exist

The coming into force of Law no. 49 dated 8 April 2016 (Law 49), has introduced in Italy a new ''level one'' set of regulatory provisions concerning, inter alia, the direct lending in Italy by EU alternative investment funds (EU AIFs) and Italian alternative investment funds (Italian AIFs), with an aim to try to cut down the scope of the banking monopoly rules.

Indeed, Law 49 supplements a series of legislative acts that have been enacted in Italy since 2012, in response to the GFC and the tightening of regulatory capital requirements for the European banks, with a view to minimising the regulatory and tax hurdles that prevented alternative finance providers from lending to Italian companies, with the intent to diversify firms' debt funding sources and compensate for the drop in bank lending, as has occurred in the UK as witnessed by the opening few Chapters of this book.

Pursuant to the banking monopoly rules, lending to the Italian public on a professional basis has been traditionally reserved in Italy to the licensed

banks and financial institutions, such as Italian banks, European banks licensed and/or passported by the Bank of Italy, non-EU banks acting through an Italian facility office and Italian financial intermediaries enrolled in a specific register held by the Bank of Italy pursuant to art.106 (the 106 Register) of the Legislative Decree no. 385, dated 1 September 1993 (Italian Banking Act), and subject to regulatory and prudential provisions broadly mirroring those applicable to banks. In this context, Law no. 116 dated 11 August 2014, (Law 116) and Law 49 have together amended the regulatory framework applicable to direct lending, granting to other entities (subject to a number of conditions), such as insurance companies, securitisation vehicles and alternative investment funds, the opportunity to enter the Italian lending market.

In fact, the possibility for the Italian insurance companies to directly advance loans to Italian borrowers, has been granted by Law 116—which has amended the Italian Banking Act and the Legislative Decree no. 206, dated 6 September 2005—upon satisfaction of the following conditions: (i) the borrowers shall be selected by a bank or by financial intermediary enrolled in the 106 Register; (ii) the bank or the financial intermediary referred to in (i) above shall retain a ''*substantial economic interest*'' in the transaction (so-called *skin in the game*); and (iii) the insurance company shall have an adequate system of internal controls and credit risk management and an adequate level of capitalisation.

As required by Law 116, on 22 October 2014 the Italian insurance supervisory authority (IVASS) enacted secondary legislation, detailing the conditions and limitations governing the direct lending by Italian insurance companies. Such secondary legislation requires insurance companies to submit to IVASS a detailed plan of their proposed lending activity, describing the process governing the selection and monitoring of the lending operations. In addition, if a bank does not assist them, they must also demonstrate their ability to manage credit risk in accordance with banking standards. The legislation makes a distinction between different categories of credit, to which specific quantitative limits apply. Finally, the new rules state that the capitalisation of insurance companies engaging in lending activity shall be evaluated taking account, at the time of writing, the future prudential regulations governing the insurance sector (Solvency II—see further Chapters 16 and 17), which differ from the existing rules that envisage a risk-based assessment of capital requirements.

As part of the efforts to enhance the role of alternative debt capital providers in the Italian market, Law 116 has amended Law no. 130, dated 30 April 1999 (Italian Securitisation Law), allowing companies established and operating under such law (the Law130 Companies) to directly advance loans to Italian borrowers by issuing notes to finance the disbursement, upon satisfaction of the following conditions: (i) the borrowers are selected by a bank or by financial intermediary enrolled in the 106 Register; (ii) the bank or the financial intermediary referred to in (i) above retains a ''skin in

the game'' in accordance with the criteria set forth in the implementing regulations to be enacted by the Bank of Italy; and (iii) the notes issued by the Law130 Company to finance the disbursement of the loan(s) are held (*detenuti*) by qualified investors (*investitori qualificati*) only.

The securitisation of loans originated by Law130 Companies is governed by the provisions of the Securitisation Law. Therefore, the receivables arising from the disbursement of the loan(s) by the Law130 Company and the relevant collections are segregated from the issuer's own assets and from the assets pertaining to other securitisation transactions (if any) carried out by the same company.

On 8 March 2016, after a public consultation process, the Bank of Italy published the regulatory implementing measures governing the granting of loans by Italian securitisation vehicles incorporated under the Italian Securitisation Law, that implements, among others, the discipline related to the retention requirements provided for under article 1*ter*, letter c) of Italian Securitisation Law.

Prior to the enactment of Law 49, it was unclear whether: (a) EU AIFs were allowed to lend into Italy; (b) AIFs could lend to consumers; and (c) lending by AIFs was subject to the same transparency requirements applying to banks and financial intermediaries. Consequently, Law 49 states that: (i) EU AIFs may, subject to certain conditions, lend directly to Italian borrowers; (ii) Italian and EU AIFs are not permitted to lend to consumers; and (iii) Italian and EU AIFs are subject to the same transparency obligations applicable to banks and financial intermediaries.

According to Law 49, EU AIFs may lend to Italian borrowers (other than Italian consumers) if the following conditions are met: (a) the EU AIF is authorised to carry out lending activities by the competent authority in its home Member State; (b) the EU AIF is set-up as a closed-end undertaking and its operational rules (including those relating to its investors) are comparable to those applicable to Italian AIFs; and (c) the rules on risk diversification and limitation (including limitations on leverage) applicable to the EU AIF under the regulations of its home Member State are equivalent to those applicable to Italian AIFs.

In addition, Law 49 also clarifies that lending by Italian and EU AIFs is subject to the transparency requirements set out under the Bank of Italy's Guidelines. This means that Italian and EU AIFs shall comply with the same pre-contractual, contractual and organisational requirements that normally apply to banks and financial intermediaries when performing lending activities in Italy. In addition, it is worth noting that the Bank of Italy may require EU AIFs to join the Italian Central Credit Register (*Centrale dei Rischi*), either directly or through third party banks or financial intermediaries.

18.3.4 Enforcement procedures and best practices seen in the Italian market as utilised by international lenders

In Italy, in the event the debtor fails to pay its debts, the bilateral relationship between creditor and debtor becomes a trilateral relationship (creditor, debtor, judicial authorities). This is due to the fact that the creditor must seek a judicial order/follow a judicial procedure to enforce his rights. In fact, any action of a creditor to collect his secured or unsecured credit must be filed before the court, which will then issue a title empowering levy execution in favour of the creditor. If such title is already in possession of the creditor (for instance cheques, bills of exchange, authenticated accounting entries, judgments), the judicial system would nevertheless be involved to regulate the repayment of the debt to the creditor by means of the sale of the debtor's goods.

An exception to the above principle can be found in the so called ''personal securities'', such as sureties and comfort letters. In such cases, if the debtor fails to pay, the creditor can require that the third party guarantor fulfil the debtor's obligations. However, the debtors can stop payment/fulfilment of the obligations by the guarantor by filing a claim to that effect before the court. In this case, the creditor will be required to go through a legal process to enforce his rights.

The assignment by way of security of receivables is one of the most common securities which borrowers grant in favour of a lender in Italy. In order to perfect a valid assignment of receivables, pursuant to art.1264, para.1, of the Italian Civil Code, the assignor shall alternatively notify to the assigned debtor or receive an acceptance of the assignment by the same assigned debtor.

In case the same receivable has been assigned, through following assignments, to a different assignee, then—pursuant to art.1265 of the Italian Civil Code—the first assignment in respect of which the assigned debtor has been notified, or which the assigned debtor has accepted and having a date certain in law (*data certa*), shall prevail in respect of the other assignments.

Upon the occurrence of an enforcement event, and at any time thereafter, the proceeds of the receivables shall become for the benefit of the secured creditors (i.e. the lenders) and may be applied by the same towards discharge of the relevant secured obligations, in the manner and order of application set out in the relevant finance documents of the transaction.

Under Italian law, a so called ''pledge in possession'' provides the secured creditor with the right to take possession of the goods secured in his favour. The pledge is enforceable with priority against third parties when: (i) the creditor has maintained the possession of the pledged asset; and (ii) the pledge has been created by means of a written instrument bearing a date certain at law (*data certa*), giving a detailed description of the secured

obligation, as well as of the relevant pledged asset. Due to the requirement of the transfer of the possession, this security cannot be utilised with reference to plants, machinery and assets that are utilised by the borrower in its ordinary course of business. Pursuant to art.2798 of the Italian civil code, the creditor can always bring an action before the court requiring that the property of the goods be awarded to the creditor, in payment of his credit, up to the full amount of the debt. The value of the goods shall be confirmed by way of appraisal conducted by independent experts or, alternatively, according to the current market price if such price exists. A similar provision also exists in cases where a credit is the object of the pledge (art.2804 of the Italian Civil Code).

Another security granted to the creditors in Italy is the mortgage over real estate assets, which is perfected and enforceable against third parties once it is executed in writing before a Notary public and registered in the Land Registry Office (*Conservatoria dei Registri Immobiliari*) of the place where the property is located. According to art.2891 of the Italian Civil Code, within 40 days of the notice (previously served), any inscribed creditor, or his surety, has a right to demand the expropriation of the property by bringing an enforcement proceeding before the President of the competent court, which has jurisdiction according to the Italian Code of Civil Procedure, provided that certain conditions are met, and notices given to interested parties.

Notwithstanding the above, as part of a wider reform process, the Italian government enacted the Decree no. 59, dated 3 May 2016, which has been converted into law on 30 June 2016 (the Decree 59), which has introduced measures aimed at, inter alia, (i) creating a floating charge called ''non-possessory pledge'' and (ii) introducing the so called ''*patto marciano*'' agreement, which allow the creditor to give rise to an out-of-court appropriation of real estate assets securing financings.

In particular the ''non-possessory pledge'' is a pledge that may be constituted by the borrowers over movable assets used for business purposes, machineries, inventory stocks or raw goods for the business of the borrowers (except for registered movable assets). Just as in the case of a possessory pledge, such non-possessory pledge must be created by means of a written instrument bearing a date certain at law (*data certa*), giving a detailed description of the secured obligation as well as of the maximum secured amount and the relevant pledged asset. Should the pledgor dispose of the object of the pledge, for example selling the relevant assets, the ''non-possessory pledge'' shall be automatically extended to the replacing goods or assets.

In order to ensure the enforceability, vis-à-vis third parties, the ''non-possessory pledge'' must be registered—being the registration valid for a 10-year period, that can be extended before the relevant maturity—with an

electronic register to be held by the Italian Tax Authorities, ensuring the possibility to have different ranking pledges over the same asset or good.

Upon the occurrence of an enforcement event, the secured creditors may alternatively: (i) dispose of the pledged asset, through a bid procedure, being the value of the pledged asset, evaluated by a third party valuer which has been appointed by the pledgor together with the secured creditor and then the proceeds of the receivables shall be for the benefit of the secured creditors (i.e. the lenders) and may be applied by the same towards discharge of the relevant secured obligations, in the manner and order of application set out in the relevant finance documents of the transaction; (ii) enforce the pledge up to the secured amount; (iii) if provided for under the relevant deed of pledge and registered with the Companies' Register, lease the asset by applying the lease receivable towards discharge of the relevant secured obligations, provided that the relevant agreement outlines the valuation criteria and mechanism, together with a detailed explanation of the secured obligations; and (iv) appropriate the pledged asset up to the secured amount, provided that the relevant agreement outlines the valuation criteria and mechanism, together with a detailed explanation of the secured obligations.

Finally, the Decree 59 introduces a new provision in the Italian Banking Act, a new article 48*bis*, entitled ''*Finanziamento alle imprese garantito da trasferimento di bene immobile sospensivamente condizionato*'', pursuant to which the repayment of the loan granted by a bank or a financial institution, authorised to grant loans to the public, can be guaranteed by the transfer to the creditor, or to an affiliate of the creditor authorised to purchase, hold and transfer property rights, the ownership of a property or other right in rem on real estate assets.

In this respect, the relevant agreement must be entered into in a notarial form and, therefore, in order to ensure the enforceability vis-à-vis third parties, ''*patto marciano*'' shall be registered with the competent Land Registry Office (*Conservatoria dei Registri Immobiliari*).

Therefore, the transfer of the ownership over the property in favour of the creditor (*sospensivamente condisionato*) is subject to the default of the debtor, which may occur if (a) non-payment continues for more than nine months after at least three—not necessarily following—instalments become due and payable, or (b) the non-payment continues for more than nine months after one instalment became due and payable, if the debtor has to reimburse the loan on a monthly basis, or (c) non-payment continues for more than nine months after the final maturity date if the reimbursement is a bullet repayment.

Upon the occurrence of an enforcement event, once the creditor has notified the borrower declaring its intention to benefit from the transfer agreement, within 60 days from such notification, the creditor shall have the right to

request the President of the Competent Court of the place where the property is located, to appoint an independent valuer in order to estimate the real estate asset, and the latter shall inform the debtor and the secured creditor of its valuation.

Finally, the abovementioned condition precedent shall be considered fulfilled if (i) the value of the property is communicated to the creditor by the independent valuer or (ii) any exceeding amount has been returned by the creditor to the debtor, in case the estimated value of the property exceeds the amount of the unpaid debt. Once the condition has been fulfilled the parties must enter into a notarial deed of confirmation.

18.3.5 Conclusion

In light of the considerations expressed above and the new legislation changes, an active market for NPLs in Italy may result in a more active role for Italian banks in supporting new lending transactions. In order to have a better organised and functioning market for the NPLs, it is necessary to create a secondary market for NPLs, which can reduce the collection burden on banks, and provide the same banks with a more cost-effective instrument, instead of the lengthy court procedures.

Finally, a well-structured Italian NPL CRE market can also support a secondary market liquidity for CRE loans, attracting the necessary investment to be made by pension funds, private equity funds and insurance companies, which may increase the extra-bank financial resources by providing the corporate sector with the required capital. Such aims are to be applauded and should be closely monitored to ensure they are collectively succeeding.