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Italy Introduces Government Guarantee to Facilitate NPL Transactions

By Alberto Del Din, Bruno Cova, Patrizio Braccioni & Annalisa Santini

Overview

Italian banks are estimated to have roughly 200 billion euros of bad loans on their balance sheets that are now hampering a recovery and limit new lending slowing down Italian economic growth. To address the issue, the Italian government has just added a new instrument to a series of measures introduced since 2014[1] and designed to facilitate economic recovery by strengthening the banking sector, so as to facilitate an effective and gradual elimination of certain weaknesses and, in particular, the existence of high levels of non-performing loans.

The measure enshrined in long-awaited Law Decree No. 18 of 14 February 2016 (the “GACS Decree”) enables the Ministry of Economy and Finance (“MEF”) to issue a guarantee (so-called “GACS”) to secure the payment obligations of Italian securitisation vehicles (“SPVs”) in relation to senior tranches of asset-backed notes (“Senior Notes”) issued by the SPVs in the context of securitisation transactions of non-performing loans carried out in accordance with the Italian securitisation law (“Law 130 of 30 April 1999”) and the further requirements set forth in the GACS Decree (“Securitisation”).

The GACS mechanism was heavily negotiated with the EU Commission, which ultimately confirmed that the new scheme – that sets the fees payable for the state guarantee at market price – is compatible with EU rules on state aids.

The GACS Decree has been published in the Italian Official Gazette on 15 February and has come into force on 16 February. As the GACS Decree was issued by the government as an emergency decree, Parliament will have to convert it into law within 60 days from its publication.

The Guarantee, Duration and Enforcement

The State guarantee is issued by the MEF as an irrevocable, unconditional and first demand guarantee to secure the payment obligations of the relevant SPV, with respect to both principal and interest, toward the holders of the Senior Notes of the Securitisation and until maturity thereof.

The Securitisation can only be implemented by way of assignment to the SPV, by banks having their registered offices in Italy, of monetary claims, including claims arising from financial lease agreements, classified as non-performing loans (NPLs).

The GACS is granted by means of a decree issued by the MEF upon (documented) request of the assigning bank. In this respect, the GACS Decree does not specify which kind of documentation is needed or, at least, required to submit the relevant request, and it is reasonable to assume that any document providing evidence that the Securitisation is structured so as to comply with all requirements set forth by the GACS Decree is to be filed with the MEF.

The GACS can be issued for a period of 18 months from 16 February 2016 with a possible further extension, to be approved with a decree of the MEF and subject to prior approval by the European Commission, for a further 18-month period.

The GACS Decree provides for the following enforcement procedure:

1. Upon failure by the SPV to pay (in whole or in part) amounts due under the Senior Notes (principal and interest), the GACS may be enforced vis-à-vis the MEF, by the holder of the Senior Notes, within nine months of the maturity date thereof.

2. The holders of the Senior Notes can submit a payment request to the SPV (through the representative of the noteholders, the "RON") after 60 days from the due date; the SPV is granted a six-month period, from the receipt of the relevant payment request, to fulfil its obligations.

3. Upon expiry of the term under (2) above, should no payment be made by the SPV, the holders of the Senior Notes may enforce the GACS.

4. The MEF will comply with its payment obligations under the GACS within 30 days from the date of receipt of the (documented) payment request (no mention to the required documentation is made in the GACS Decree).

Amounts paid under the GACS will equal payments to be made to senior noteholders in the context of the Securitisation, *i.e.* no default/additional interest or penalty whatsoever shall be covered under the GACS. The MEF is then subrogated in all rights of the senior noteholders with respect to amounts paid under the GACS, subject to any contractual limitations under the Securitisation.

Conditions for the Effectiveness

As briefly mentioned above, the GACS is a measure aimed at facilitating the dismissal by the Italian banks of the pile of NPLs accumulated during the past years and, as condition for its effectiveness, the GACS Decree requires that the selling bank assigns junior notes held by it in an amount equal, at least, to 50% plus 1 of the junior notes issued and subscribed by the SPV and, in any case, such amount of junior notes (and, if any, mezzanine notes) that allows the selling bank to derecognize the relevant portfolio from its balance sheet (and, at group level, from the consolidated balance sheet) on the basis of the accounting principles applicable to banks.

The GACS is remunerated at a market level, thus avoiding its characterisation as a state aid according to EU rules. Its remuneration is to be paid annually and to be determined according to the methodology set forth in the GACS Decree, based on three different baskets of CDS (attached to the decree) each of which relating to different Italian issuers and to different ratings of the Senior Notes issued in the context of the Securitisation. The remuneration increases during the years so as to incentivise an accelerated recovery of the NPLs backing the notes. The MEF is also allowed to change the methods of calculation of the remuneration according to decisions of the European Commission (without affecting transactions existing at that time).

Payments of the remuneration will be made out of the recoveries of the NPLs and will rank senior to payments due to hedging counterparties and to senior noteholders, but junior to payments of taxes, servicers' and agents' fees and interest accrued on the liquidity line (if any).

The Senior Notes

Senior Notes (and mezzanine notes, if any) shall be remunerated with a floating interest rate, which will be payable in arrears quarterly, semi-annually or annually.

Principal repayments prior to the maturity date of the Senior Notes will be made out of cash flows deriving from the recovery of the assigned receivables net of all costs connected to the collection and recovery of the relevant NPLs.

As a further condition to the issuance of the GACS, it is required that a rating be assigned to the Senior Notes by one of the rating agencies recognized by the European Central Bank (External Credit Assessment Institutions, "ECAI") not lower than the lowest "investment grade" level. The same minimum rating level applies to any additional rating required by any applicable provisions of law. Alternatively, a private rating can be provided for the benefit of the MEF and in this case the relevant ECAI shall also be approved by the MEF. The SPV shall undertake not to request the rating withdrawal until full repayment of the Senior Notes.

Securitisation Structure

In addition to the main requirements of the Italian securitisation, the following requirements should be met for the issuance of the GACS:

1. NPLs to be assigned for a value not higher than their net book value (gross book value net of specific provisions);

2. issuance of, at least, two classes of notes, with different ranking (a mezzanine tranche can also be issued);

3. full subordination (for principal, interest and other amounts) of the junior notes to any other notes;

4. possibility to issue one or more classes of mezzanine notes whose interest will rank junior to interest of the Senior Notes and may rank senior to the principal of the Senior Notes;

5. hedging agreements may be entered into by the SPV to cover the risks of interest rate mismatch between assets and liabilities of the securitisation; and

6. a liquidity line may be made available to the SPV to cover the risk of mismatch between the recoveries of the NPLs and interest amounts due under the Senior Notes, to be tailored on the rating of such Notes.

The servicer of the Securitisation ("NPLs Servicer") shall be independent from the assigning bank (*i.e.* shall not belong to the same group of the latter), thus avoiding potential conflicts of interest. Any decision to replace the existing NPLs Servicer shall not adversely affect the rating level of the Senior Notes.

A securitisation waterfall is also provided by the GACS Decree. In summary, according to such waterfall, interest on the Senior Notes shall rank after (i) taxes (if any), (ii) amounts due to agents and servicers, (iii) interest on the liquidity line (if any), (iv) GACS' remuneration, and (v) amounts due to hedging counterparties. Principal repayments under the Senior Notes will rank junior to principal repayments under the liquidity line (if any) and interest payments under the mezzanine notes (if any). Principal, interest and any other amount due under the junior notes shall be fully subordinated to any other payment.

Tax-related Matters

In addition to other innovations related to direct taxation in the context of corporate insolvencies and banking resolutions procedures (bail-in and bridge-entities), the GACS Decree introduces a very favourable registration tax (*imposta di registro*) regime for the acquisition of real estate assets in the framework of mortgage enforcement/foreclosure proceedings.

Such innovation resides in the application of a flat €200 transfer tax on the acquisition of real estate in the framework of enforcement/foreclosure procedures, thus greatly reducing the transfer costs of foreclosed real estate assets securing NPLs. This provision is intended to facilitate an increase of the transfer price of such assets and the recovery value of the relevant NPLs.

The reduced registration tax applies if the property is sold by its buyer within two years from its acquisition.

If resale is not accomplished within two years, the buyer will pay the full 9% registration tax plus 30% penalties, and interest.

The new rule is expected to facilitate the disposal of real estate deriving from insolvency and mortgage enforcement proceedings and enhance the recovery of the real estate market. It is expected that the measure will be of particular interest to those real estate market players who have the ability to dispose of the assets within two years.

A Useful Tool, But Not Enough

The provision for a government guarantee to secure payment obligations of Securitisation SPVs has been welcomed by Italian banks, which will have another instrument to address their NPL problems.

The measure has, however, been greeted with a certain degree of disappointment by other investors, who had been eagerly following the discussions between the Italian government and the EU and were expecting more effective measures. The disappointment was likely a factor in the recent poor performance of Italian banks' equities.

Surely, the Italian Government has made a further effort to expand the set of measures enacted in the past months in favour of the Italian banking system with the aim to speed up the process of building-up a stronger banking system (helping Italian banks to offload their non-performing loans portfolios, which have strong impact on their balance sheet and capability to grant new loans on the market and help the recovery of the Italian economy).

The GACS could allow Italian banks to sell the NPLs at a better price and this could raise the incentive for banks to sell them, by reducing the losses they may have to record on their books. However, given the costs for obtaining the GACS (which is priced at market price) and the gap, still high, between the price being offered by potential buyers for NPLs and their (net) book value, the new measure is unlikely to be sufficient to bridge the pricing gap, thus fully addressing the balance sheet issue of Italian banks and fully relaunching the NPL market.

As the GACS Decree will have to be converted into law by Parliament within 60 days, there is a possibility that the government – prompted by the lukewarm reception of the measure by investors – will take advantage of this time to introduce improvements to the measure, transforming it into a more innovative and flexible instrument. Leveraging on another feature introduced through the GACS Decree, the opening of direct lending activities to European funds (which will be covered in a separate Client Alert), the Government could consider introducing provisions allowing the GACS to be extended to cover super-senior notes issued to obtain new money to be invested in the underlying assets. In this way, NPL portfolios consisting of loans granted to industrial corporations could be managed with a view to facilitating the turnaround of the underlying business by granting new financing through the SPVs and increasing the IRR of the relevant NPLs portfolio thus feeding the investors' appetite for this kind of investments.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Milan lawyers:

Bruno Cova
39.02.30414.212
brunocova@paulhastings.com

Patrizio Braccioni
39.02.30414.210
patriziobraccioni@paulhastings.com

Alberto Del Din
39.02.30414.288
albertodeldin@paulhastings.com

Annalisa Santini
39.02.30414.224
annalisasantini@paulhastings.com

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[1] Among the various measures introduced by the Italian government to facilitate restructurings and to open to alternative lending: (i) measures meant to boost the competitiveness of the Italian economy in July 2014 that followed the introduction of a competitive legal framework for the issuance of listed bonds by non-listed companies (mini-bonds) and the implementation of the alternative investment fund managers directive (see client alert of July 07, 2014) (ii) Law decree No. 91 of 24 June 2014 to promote growth and increase the competitiveness of the Italian economy encouraging equity investments into listed and non-listed companies (see client alert of October 01, 2014) (iii) Law No. 154 of 7th of October on certain reforms of banking and finance legislation (see client alert of November 17, 2014) (iv) the reform of mutual banks (see client alert of March 25, 2015) (v) the reforms of the Bankruptcy Act and enforcement proceedings (see client alert of August 2015 July 06, 2015) (vi) further amendments of the Bankruptcy Act to strengthen the creditors' protection (see client alert of September 10, 2015)