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Alternative Lending: The Italian Market Opens to EU Credit Funds

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Background

Following the new measures issued by the Bank of Italy on 23 December 2016 (the “BoI Regulation”¹), EU credit funds may now lend to Italian non-consumer borrowers, *provided* that they register with the Bank of Italy.

The BoI Regulation completes the regulatory framework on lending into Italy by EU credit funds by enacting the level 1 measures recently introduced in Legislative Decree 24 February 1998 No. 58 (the “Unified Financial Act”²). Following the adoption of the BoI Regulation, the regulatory framework for alternative lending by both domestic and EU credit funds has been aligned.³

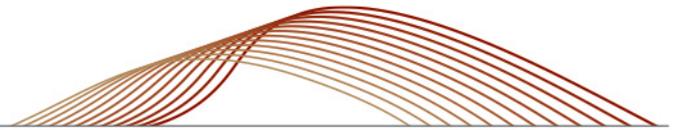
This alert focuses on the direct lending by EU credit funds reserved to professional investors only⁴ and, in particular, on the following:

- i) conditions for lending into Italy by EU credit funds;
- ii) procedure to be followed prior to start operating; and
- iii) reporting and disclosure duties.

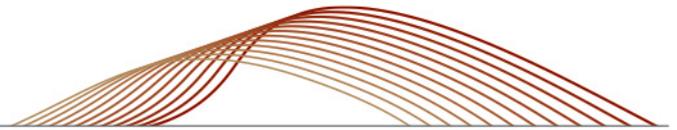
It is worth reminding that, under Italian law, the purchase of receivables falls within the wider lending activity notion (so called “*attività di concessione di finanziamenti*”) and this rule has also recently been stressed by the Bank of Italy in the framework of the public consultation during 2016.⁵ Consequently, the EU credit funds willing to buy existing loans should be considered as being in principle subject to the direct lending regime subject matter of this alert.

I. Conditions for Lending into Italy By EU Credit Funds

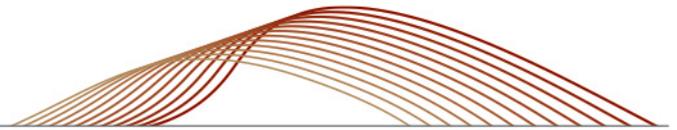
REQUIREMENT	COMMENTS / IMPLICATIONS
<p>1. <u>Fund type</u>: the investment fund must be an EU AIF, i.e., an undertaking for collective investment “falling within the scope” of Directive 2011/61/EU (the “AIFMD”), which is established in an EU member state other than Italy.</p>	<ul style="list-style-type: none"> • EU investment funds, which fall outside the scope of the AIFMD either because they do not meet the “AIFs” definition in Article 4(1) or pursuant to Articles 2(3) and 3(1) thereof (e.g., family offices, holding companies, securitisation vehicles, joint ventures, pension funds, employee participation or savings schemes, funds whose sole investors are the investment manager and/or its affiliates) would not qualify.



		<ul style="list-style-type: none"> • So-called small EU AIFs, which <i>are exempted from</i> the scope of application of a large part of the AIFMD pursuant to Article 3(2) thereof appear unlikely to qualify, as long as they do not opt-in under the AIFMD. • When it becomes possible for non-EU AIFMs to manage EU AIFs under the single authorisation regime of Article 37 of the AIFMD, EU AIFs managed by non-EU AIFMs should qualify. • Non-EU AIFs, regardless of the nationality of their fund manager, would not qualify.
2.	<p><u>Authorisation in the home member state:</u> the EU AIF must be authorised by its home regulator to invest in loans in its home member state, including loans originated by the AIF itself.</p>	<ul style="list-style-type: none"> • The authorisation can be express (e.g., for regulated funds in EU countries which provide for some form of lending restriction, it can be set out in statutory instruments and then confirmed by the home regulator's authorisation of the individual AIF), in which case the relevant documentary evidence should be provided to the Bank of Italy. • The authorisation should also be deemed in place when it is not express but can be derived from the overall legal framework applicable to lending and investment funds in the home jurisdiction (e.g., in EU countries where there is no lending restriction and investment funds are allowed to invest in loans, including those which they originate) pursuant to the rules pointed out under Section II ("<i>Procedures to be complied by EU credit funds carrying out Italian lending transactions</i>").
3.	<p><u>Authorisation in Italy:</u> the manager of the EU AIF must notify the Bank of Italy of its intention to engage in lending in Italy and the EU AIF may not start operations until 60 days have passed from this notification, within which deadline the Bank of Italy may deny permission to lend directly in Italy based on the BoI Regulation's terms and conditions as pointed out under Section II ("<i>Procedures to be complied by EU credit funds carrying out Italian lending transactions</i>").</p>	<ul style="list-style-type: none"> • As this is not a matter covered by any European Directive, the assessment by the Bank of Italy is unlikely to be a rubber-stamp exercise and will entail a review of the merits of the application and of the supporting documentation.
4.	<p><u>Investors:</u> the EU AIF must be in closed-ended form and its framework of operation ("<i>schema di funzionamento</i>"), particularly as regards investors' participation, must be similar to the one of Italian credit funds.</p>	<ul style="list-style-type: none"> • The concept of 'framework of operation' focuses in particular on terms for subscription and redemption of the units / shares, scope, and investment policy as pointed out under Section II ("<i>Procedures to be complied by EU credit funds carrying out Italian lending transactions</i>").



		<ul style="list-style-type: none"> Considering that investment and concentration limits are separately addressed in point 5 below, that the provisions on custodians and disclosure to investors are now set uniformly by the AIFMD, and that closed-ended Italian investment undertakings can now be set up also under statute (in the form of investment companies with a fixed capital, so-called "Sicaf"), this requirement should mainly refer to the provisions identifying the EU AIF's target investors and governing their participation in the fund, including, <i>inter alia</i>: <ul style="list-style-type: none"> (i) the requirement that investment in the EU AIF be restricted to professional investors (as defined by the AIFMD by reference to the concept of professional clients under MIFID) and semi-professional investors (i.e., non-professional investors who subscribe for or purchase units in the fund for an amount not lower than €500,000); and (ii) the maximum duration of the fund, which may not exceed 50 years. EU credit funds may not invest in loans with a maturity longer than the credit fund's one and may incur debt from banks, licensed financial intermediaries and other entities authorised to originate loans only.⁶
5.	<p><u>Leverage and concentration limits</u>: the home member state's provisions on risk management, concentration limits, and permitted leverage must be equivalent to the provisions applicable to Italian credit funds. This equivalence may be established also solely on the basis of the EU AIF's fund rules or constitutional documents, <u>provided</u> that the home regulator ensures compliance with such provisions.</p>	<ul style="list-style-type: none"> Italian credit funds reserved to professional and semi-professional investors are subject to a 1.5 leverage limit and a 10% concentration limit. Newly created funds are exempt from compliance with the concentration limit for six months since the date of beginning operations. The Italian measures on leverage and concentration limits constitute a floor and therefore they may not be derogated.
6.	<p><u>Borrower type</u>: no lending to consumers will be allowed.</p>	<ul style="list-style-type: none"> This restriction applies across the board to all other entities newly authorised to engage in lending in Italy (Italian and EU insurance companies, Italian securitization vehicles,⁷ Italian credit funds).
7.	<p>Regulatory duties in Italy – the EU AIF:</p> <ul style="list-style-type: none"> i) is subject to the reporting obligations to the Bank of Italy pointed out under Section III ("<i>Reporting and disclosure duties</i>"); ii) may be required to take part, including through an Italian bank / 	<ul style="list-style-type: none"> Although the BoI Regulation has come into force, it remains still unclear whether or not EU credit funds shall take part of the Italian Central Credit Register. Pursuant to Article 46 – ter, paragraph 3 of the Unified Financial Act, the Bank of Italy may require that EU credit funds take part of the Italian Central Credit Register. Based on the



	<p>licensed financial intermediary, in the Italian Central Credit Register ("<i>Centrale dei Rischi</i>");⁸ and</p> <p>iii) is subject to the provisions on transparency of contractual terms applicable to bank loan agreements, for which the fund alternative investment manager will be responsible.</p>	<p>introductory non-binding note to the July 2016 Bank of Italy public consultation paper, it appeared that EU credit funds would have taken part of the Italian Central Credit Register. However, neither the BoI Regulation nor any other measures tackle this issue; although it looks likely that EU credit funds shall be required to take part of the Italian Central Credit Register.⁹ One may expect that EU AIFs authorised to lend in Italy may establish an on-going service relationship with a local financial intermediary, to which compliance and record-keeping in respect of all the regulatory duties mentioned in this point 7 may be outsourced.</p> <ul style="list-style-type: none"> • In addition to the transparency measures, it is worth noting that (regardless of their governing law) alternative lending transactions shall also be subject to traditional mandatory Italian law provisions of the credit transactions (notably usury and compounding of interest).
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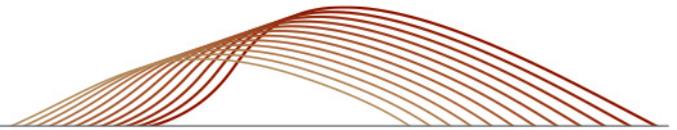
II. Procedures to Be Complied By EU Credit Funds before Carrying Out Italian Lending Transactions

EU licensed alternative fund managers managing EU credit funds shall file a notice at least 60 days in advance with the Bank of Italy (the "BoI Notice") before starting any direct lending. Certain activities preliminary to lending may be carried out prior to the filing of the BoI Notice (e.g., scouting of investment opportunities).

A number of documents shall be attached to the BoI Notice (see below) and may be drafted either in Italian or in English.

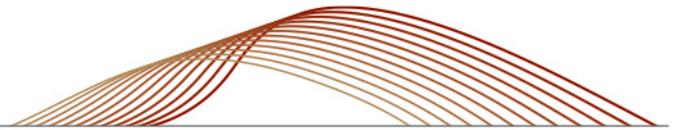
The chart hereunder summarizes the documents which shall be attached to the BoI Notice with reference to the following issues: x) Licensing; y) Functioning scheme; and z) Rules on risk spreading.

BoI NOTICE ATTACHMENTS		COMMENTS
Licensing matters		
1.	<p>Competent EU home member supervisory authority statement confirming that the EU credit fund's alternative fund manager is authorized to manage:</p> <ul style="list-style-type: none"> i) alternative investment funds into its EU home member state; and ii) the EU credit fund to which the BoI Notice makes reference. 	<ul style="list-style-type: none"> • The statement may be executed on a free basis since the BoI Regulation does not provide for any specific form of execution (e.g., execution of the statement <i>vis-à-vis</i> a public notary).



	In lieu of applying for the statement, the EU credit fund alternative fund manager may file a copy of its authorization to manage alternative investment funds together with a statement executed by its legal representative confirming the alternative fund manager's enrolment under the relevant alternative investment fund manager's register.	
2.	Competent EU home member supervisory authority statement confirming that the EU credit fund may carry out lending transactions. In lieu of applying for the statement, the EU credit fund alternative fund manager may request a legal opinion ("LO"). The LO shall be ruled by the same law ruling the EU credit fund and shall confirm the EU credit fund's capacity to carry out lending transactions.	<ul style="list-style-type: none"> No comments.
3.	Copy of both the EU credit fund's and the alternative fund manager's constitutive documents together with the competent EU home member supervisory authority statement confirming that the constitutive documents are still into force. In lieu of applying for the EU home member supervisory authority statement, the EU credit fund alternative fund manager may execute a statement confirming that the EU credit fund's alternative fund's managers constitutive documents are still in force.	<ul style="list-style-type: none"> The statement may be executed on a free basis since the BoI Regulation does not provide for any specific form of execution (e.g., execution of the statement <i>vis-à-vis</i> a public notary).

BoI NOTICE ATTACHMENTS		COMMENTS
Rules on risk spreading		
4.	Alternative fund manager's statement pointing out the EU home country rules applying to the EU credit fund and which may qualify as equivalent to the rules applying to Italian credit funds.	<ul style="list-style-type: none"> A copy of the home country rules shall be attached to the BoI Notice. The statement may be executed on a free basis since the BoI Regulation does not provide for any specific form of execution (e.g., execution of the statement <i>vis-à-vis</i> a public notary).
5.	Legal opinion confirming that the EU home country rules applying to the EU credit fund are equivalent to the ones applicable to Italian credit funds.	<ul style="list-style-type: none"> No comments.

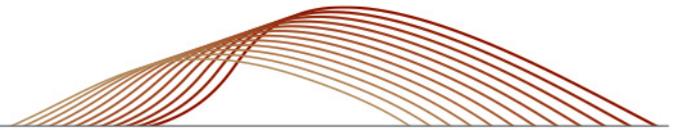


6.	Competent EU home member supervisory authority statement ensuring that the authority supervises the alternative manager to make sure that the manager complies with the EU credit fund's constitutive documents in terms of risk containment, risk spread, and leverage limits. One may provide the statement in lieu of the legal opinion per point 5 above.	<ul style="list-style-type: none"> No comments.
Functioning scheme		
7.	<p>Memorandum on the EU credit fund functioning scheme. The memorandum shall focus on the following issues:</p> <ul style="list-style-type: none"> i) units / shares subscription terms; ii) scope; iii) investment policy; and iv) redemption. The memorandum shall point out if the EU credit fund may enter / will enter into side letters with a number of investors. 	<ul style="list-style-type: none"> One may assume the memorandum shall not tackle any further information on the EU credit fund's functioning scheme other than the information per items from i) to iv) of this point 7, although the BoI Regulation does not expressly deal with this issue.
8.	<p>Copy of the last EU credit funds:</p> <ul style="list-style-type: none"> i) annual report; and ii) last half yearly report (if available). 	<ul style="list-style-type: none"> An EU credit fund may carry out lending transactions into Italy <i>provided</i> that the EU credit fund has already drawn-up at least its first annual report. Therefore newly formed EU credit funds may not carry out lending transactions into Italy.

III. Reporting and Disclosure Duties

The EU credit fund alternative fund manager:

- i) shall send to the Bank of Italy the EU credit fund's annual report within 10 days from the annual report approval date;
- ii) shall promptly disclose to the Bank of Italy any amendments to the information pointed out under Section II ("*Procedures to be complied by EU credit funds carrying out Italian lending transactions*"). It looks unclear to what kind of amendments the disclosure duties apply. For instance it is unclear if the alternative fund manager shall disclose to the Bank of Italy any kind of amendments carried out with reference to the manager's EU credit fund constitutive documents including amendments of a non-material nature; and
- iii) may be required to take part of the Italian Central Credit Register and therefore the EU credit fund alternative manager shall report to the Bank of Italy certain data relating to the loans granted into Italy per the terms and conditions which still need to be pointed out by the Bank of Italy.¹⁰



IV. Limited Italian Supervision (So Called “*Vigilanza Informativa*”) Carried Out on EU Credit Funds Lending into Italy

EU credit funds carrying out Italian lending transactions are not subject to the Bank of Italy's prudential supervision. However, the Bank of Italy and the financial Commissione Nazionale per le Società e la Borsa (“CONSOB”) may request that alternative fund managers disclose any information and data relating to their Italian lending business.¹¹

Concluding Remarks

Following the entry into force of the BoI Regulation, Italy has a comprehensive set of measures disciplining alternative lending. EU credit funds can now play an active role in the Italian lending market with no need to apply for a banking license. The new measures also allow banks to develop strategies based on lending platforms with EU credit funds so as to lighten the burdensome Basel III prudential capital requirements.

The BoI Regulation is in addition to the other alternative lending instruments introduced in the last few years, i.e., mini-bonds and the use of securitization vehicles,¹² thus providing investors and borrowers with a menu of options, and must be read in the context of a significant strengthening of creditors' rights through various legal reforms, including changes to the Bankruptcy Act, accelerated court enforcement proceedings, and novel security instruments.¹³



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

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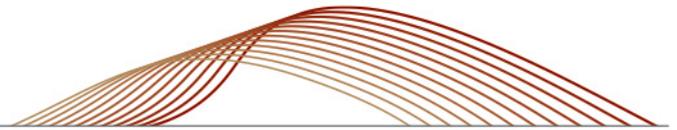
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- ¹ The BoI Regulation: i) was issued following the July 2016 Bank of Italy public consultation relating, *inter alia*, to EU credit funds; ii) was published on the Italian Official Gazette 4 January 2017 No. 3; and iii) entered into force on 5 January 2017.
- ² Reference is made to Articles 46 - *ter* and *quarter* of the Unified Financial Act with a particular emphasis on the amendments introduced by Article 17 of Legislative Decree 14 February 2016 No. 18 as converted into Law with amendments by Law 8 April 2016 No. 49. See our previous Client Alert: "*Alternative Lending in Italy: A Significant Step Forward*" (February 2016).
- ³ Both credit funds had been expressly authorised under the recent changes to the Unified Financial Act but the lending by EU Credit Funds was subject to the implementing regulations.
- ⁴ As instance reference is made to the following kinds of professional investors: i) credit institutions; ii) investment firms; iii) pension funds; iv) insurance companies; and v) collective investment schemes and their management companies, etc.
- ⁵ In this regards please make reference to the Bank of Italy paper "*Modifiche al regolamento sulla gestione collettiva del risparmio – Attuazione della Direttiva UCITS V e altri interventi di modifica – Resoconto della consultazione,*" page 10 re: "*Disposizioni generali (Ambito di applicazione).*" The paper is available in Italian version only at the following address: http://www.bancaditalia.it/compiti/vigilanza/normativa/consultazioni/2016/gestione-collettiva-risparmio/Resoconto_consultazione.pdf.
- ⁶ In this regards please make reference to the Bank of Italy paper "*Modifiche al regolamento sulla gestione collettiva del risparmio – Attuazione della Direttiva UCITS V e altri interventi di modifica – Resoconto della consultazione,*" page 11 re: "*Condizioni per operare in Italia (Condizioni).*" The paper is available in Italian version only at the following address: http://www.bancaditalia.it/compiti/vigilanza/normativa/consultazioni/2016/gestione-collettiva-risparmio/Resoconto_consultazione.pdf.
- ⁷ Italian and EU insurance companies and Italian securitization vehicles are actually subject to a broader restriction since they may not lend to individuals generally and to micro-enterprises (as defined by the European Commission Recommendation 2003/361/EC).
- ⁸ The Italian Central Credit Register is an informative system pointing out the level of indebtedness undertaken by each borrower *vis-à-vis* domestic banks and financial institutions. Domestic banks and financial institutions shall report on a monthly basis to the Bank of Italy: i) the aggregate overall amount of client loans; ii) the single amount of client loans higher than €30,000; and iii) any non-performing loans irrespective of their amount. Any data collected by the Bank of Italy is confidential and is disclosed only to domestic banks and financial institutions taking part to the Italian Central Credit Register on a monthly basis.
- ⁹ The Bank of Italy is still analysing it based, *inter alia*, on the comments received by the market participants during the public consultation process. Certain market participants proposed to adopt a safe harbor exemption mechanism in relation to overall loans originated under a *de minimis* threshold so as to mitigate any duties arising from the taking part by EU credit funds to the Italian Central Credit Register.
- ¹⁰ For more information please make reference to the considerations set forth under previous Section I ("*Conditions for Lending into Italy by EU Credit Funds*"), paragraph 7.
- ¹¹ Article 8, paragraph 1 of the Unified Financial Act.
- ¹² See our previous Client Alert "*Italy Introduces Measures to Facilitate Alternative Funding*" (July 2014) and "*The Changing Face of Italian Insurance Companies*" (November 2014).
- ¹³ See our Client Alerts "*Italy Amends Bankruptcy Act and Other Laws to Facilitate Restructurings and Reinforce Creditors' Rights*" (July 2015); "*Italy Finally Approves Statute Amending Bankruptcy Act and Other Laws to Facilitate Restructurings and Reinforce Creditors' Rights*" (September 2015); and "*Italy Introduces New Tools for Securing Financings and Strengthens Enforcement Procedures*" (May 2016).

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