State guarantee on NPLs securitisations

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Law Decree No. 18 of 14 February 2016 ("the **Decree**"), published in the Official Gazette on 15 February 2016, brought in some urgent measures in support of the Italian banking system; among them, a regime for the grant of a state guarantee on notes issued in the context of securitization transactions of non-performing loans classified as "*sofferenze*" ("**NPLs**"). This is to facilitate the disposal of the stock of NPLs currently held by Italian banks. The Decree must be converted into a law within 60 days of its publication. The Ministry of the Economy and Finance ("**MEF**") may issue a ministerial decree setting out implementing regulations within 60 days from the date of conversion.

The characteristics of the state guarantee (referred to in the decree by the acronym "**GACS**" - *Garanzia Cartolarizzazione Sofferenze* or Securitisation Guarantee for NPLs) were discussed at length, and finally agreed, between the Italian Government and the European Commission, to ensure its compatibility with European legislation on state aid. Any significant changes to the guarantee scheme outlined in the Decree, when the Decree is converted into law, will therefore have to be considered in advance and approved by the European Commission.

1. Scope of application

The MEF is authorized, for eighteen months from the date of entry into force of the Decree, to provide a state guarantee to the senior notes issued by securitization vehicles in the context of securitization transactions pursuant to Law 130 of 1999 which relate to monetary receivables (*crediti pecuniari*), including debts arising from leasing agreements, classified as NPLs and held by banks that have their registered office in Italy. To be eligible to benefit from the state guarantee a securitization must also comply with specific structural requirements provided for in the legislation and set out below.

The MEF can extend this period up to a maximum of a further 18 months, with the approval of the European Commission.

2. Characteristics of the securitization

2.1. Structure

The NPLs must be transferred from the selling bank to the securitization vehicle ("**SPV**") for a price that is not higher than the net book value (gross value net of adjustments).

The management of the debt must be entrusted to a third party (a NPLs Servicer) independent of the selling bank and which does not belong to its group. Such entity may be replaced by holders of the notes during the life of the transaction on condition that this does not cause a deterioration of the credit rating of the senior notes.

The SPV must issue at least two classes of notes, senior and junior, and may also issue mezzanine notes. Junior note holders will not be entitled to interest, repayment of capital nor any other form of remuneration until full redemption of the senior and mezzanine (if issued) notes.

The senior notes must have a rating, assigned by an external credit assessment agency ("ECAI"), that is not less than the last rung of the rating scale for investment grade debt. The SPV cannot request the revocation of the rating until the senior notes have been repaid in full.

The senior and mezzanine notes must pay interest at a floating rate quarterly, half-yearly or yearly. In addition, payments on mezzanine notes can be deferred under certain conditions or can be linked to performance targets in the collection or recovery of the transferred NPLs.

To facilitate a successful outcome of the securitization transactions there may also be forms of credit enhancement through the activation of a credit line (the Liquidity Line), or by entering into hedging agreements on interest rates.

2.2. Priority of payments

The sums raised through recoveries and from collections in relation to the portfolio of securitized loans, as well as from the hedging agreements and the utilizations under the credit line, net of amounts withheld by the NPLs Servicer for its management activities, must be applied in the order set out below:

(a) taxes;

(b) amounts owed to service providers;

(c) interest and fees relating to any credit line;

(d) payments due in relation to the grant of the GACS;

(e) payments of the amounts owed to counterparties of any hedging agreements;
interest on the senior notes;

(f) repayment of the principal under the credit line (if any);

(g) interest on the mezzanine notes (if issued);

(h) full repayment of principal of the senior notes;

(i) full repayment of principal of the mezzanine notes (if issued); and

(j) payment of the amounts due in respect of the principal, interest and any other form of remuneration on the junior notes.

3. The state guarantee (GACS)

3.1. The nature of the guarantee

The GACS is granted for the benefit of the holders of the senior notes following a written application to the MEF from the selling bank. It is unconditional, irrevocable and first demand and covers, for the entire term of the senior notes, payments of principal and interest.

The guarantee becomes effective only when the selling bank has transferred, for consideration, at least 50% + 1 of the junior notes or, in any case, junior notes and, if issued, mezzanine notes, for an amount allowing the derecognition of the receivables which are the subject of the transaction from the financial accounts of the transferring bank.

It is granted in exchange for an annual fee determined at market conditions, taking into account the three baskets of CDS (credit default swaps) relating to individual Italian issuers whose rating issued by S&P, Fitch and Moody's, is rated at a level at least equal to the investment grade corresponding to that assigned to the senior notes to be covered by the guarantee.

The annual fee is calculated on the residual value of the senior notes at the beginning of the interest payment period and is determined as follows:

(a) for the first three years, the simple average of the prices of individual three year CDS included in the CDS basket of reference;

(b) for the next two years, the simple average of the prices of individual five year CDS included in the CDS basket of reference; and

(c) for subsequent years, the simple average of the prices of individual seven years CDS included in the CDS basket of reference.

A surcharge is added to the fixed fee mentioned above if the senior tranche has not been repaid by the third year.

The MEF can change, in accordance with decisions of the European Commission, the annual fee or the calculation criteria, but any changes will not affect GACSs that are already in place.

3.2. Commencement and calls on the GACS

The beneficiary of the GACS can enforce the guarantee within nine months from the maturity of the senior notes, in case of non-payment, which may be partial, of the amounts due for principal or interest that remain outstanding for at least 60 days after the relevant payment date. Before enforcing the guarantee, the holders of the senior notes, jointly and through the representative of the noteholders (RON), must send to the SPV a request for payment of the amount overdue and not paid. After the expiry of 30 days, and within six months from the date of the request to the SPV, the senior note holders may call on the state guarantee.

After a call on the GACS, the MEF, being subrogated to the holders of the senior notes as a result of its payment, will recover the amount so paid, together with interest at the legal rate and the costs incurred in the recovery of such amounts.

4. Preliminary considerations

The measure of success of the GACS in encouraging the disposal of the stock of NPLs accumulated by the Italian banks will be determined by various factors, including, in particular:

(a) **a sufficient reduction of the gap between the price offered by investors and that sought by the banks that are transferring the NPLs** - if, on the one hand, the state guarantee permits a saving in terms of reduction of the rate of interest accruing on the senior notes, on the other hand, the saving may not be enough to fill this gap. It is necessary to take into account that the saving obtained will be, at least in part, eroded by the cost (market) of the guarantee and the cost of obtaining and maintaining the rating, as well as the fees of the independent servicing of the NPLs (that banks are not permitted to carry out themselves);

(b) **the speed of implementation of the GACS regime** - it may be time-consuming because the rating agencies will have to draw up or update the criteria for this category of assets (NPLs) and carry out their analysis on the first portfolios seeking to benefit from the state guarantee;

(c) **the interests of investors** - investors who traditionally buy, including through securitization, NPLs normally expect some returns in a short period of time and this may not be in line with being entirely subordinated to the senior tranche (the only one benefitting from the GACS) and only being repaid when the senior notes have been fully repaid;

(d) **the possibility of the banks using the senior notes as collateral in refinancing operations with the ECB** - this possibility does not seem to be currently contemplated by the ECB's measures, but

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could represent a benefit in terms of liquidity for the banks, which would promote the development of assisted securitization benefitting from the state guarantee; and

(e) **the ability to select suitable portfolios suitable in order to achieve the required rating** - the possibility of obtaining an investment grade rating on senior notes will probably also depend on the ability of the selling bank to select loan portfolios backed up by appropriate documentation, something that may not be easy in the case of aged portfolios or portfolios acquired through one or more extraordinary transactions.