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ITALIAN FINANCE MINISTRY ANNOUNCES GOVERNMENT GUARANTEE SCHEME FOR ITALIAN NPL SECURITISATIONS

Last Tuesday after months of negotiations, Italy finally reached an agreement with the EU regarding a solution to the Italian banks' non-performing loans problem with a scheme that has been confirmed does not constitute State aid.

Broadly, rather than create a "bad bank", it has been decided that the Italian government will guarantee senior tranches of securitisation ABS backed by NPLs.

Details of the scheme are described in a press release published by the Italian Ministry of Finance on 27 January 2016 and are summarised below. It is expected that a *Decreto Legge* will be passed in the coming weeks converting the proposal into law.

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Summary

- **State guarantee of senior ABS backed by NPLs**
- **Guarantee fee will increase over time, price linked to single name CDS**
- **Guaranteed tranche must have investment grade credit rating**
- **Independent servicer**

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State guarantee of senior ABS backed by NPLs

The scheme envisages a State guarantee for asset-backed securities issued as part of a securitisation transaction whose underlying assets are non-performing loans.

The guarantee will only cover the most senior tranche of notes, and the mezzanine and junior tranches must be fully subordinated to such guaranteed senior tranche.

Guarantee fee will increase over time

A fee for the guarantee will be payable to the Treasury being an annual percentage of the amount guaranteed. The European Commission is satisfied that this does not constitute State aid as the guarantee will be charged at market prices calculated on the basis of single name credit default swaps on Italian issuers with a risk level equal to that of the guaranteed securities.

The guarantee fee will increase over time, both to cover for the higher risk associated

with longer duration of the bonds and to create an incentive for early recovery of the underlying debt.

The price for the first three years is expected to be calculated as an average of the mid-price of three-year benchmark CDS for issuers with a rating equal to that of the guaranteed tranches. In the fourth and fifth year the price will increase after the first step up (5-year CDS) and from the sixth year onwards the guarantee will be fully priced (7-year CDS). In addition, after three years there will be a supplemental incentivizing premium (which increases over time) to offset the lower rate paid at the outset.

Investment grade credit rating

The guaranteed ABS must have an investment grade credit rating from at least one independent rating agency accepted by the Eurosystem. The rating analysis will therefore include projections on the cash flows, analysis on the credit quality of the underlying loans, tranching of the different classes of ABS and the ability of the servicer appointed by the issuer to recover the underlying debt.

Independent servicer

The ABS issuer will be required to appoint an external independent servicer to recover the underlying debts (rather than the originator bank) in order to prevent conflicts of interest.

Although the final details of the scheme will not be known until the legalisation is finalised, indications are that this could help to alleviate the serious problem of non-performing loans on the balance sheets of Italian banks, which are estimated to make up around 17% of total loans, as compared with the EU average of 6%.