"New provisions approved by the Italian government in relation to Non-Performing Loan Guarantees ("NPL Guarantees")"

Summary: Introduction. 1. Scope and transaction structures. 2. Terms and Conditions of the notes. 3. Priority of Payments. 4. NPL Guarantee. 4.1 Conditions for grant. 4.2 Premium. 4.3 Enforcement.

On 15 February 2016 the Italian Government published Law Decree no. 18 that introduced a series of measures to assist the financial sector, among which is a State guarantee mechanism on the disposal of non-performing loans (NPLs) by Italian banks. The economic effect of the guarantee would be to reduce the amount of NPLs on banks' balance sheets.

The new law specifies the requirements as to the duration of the guarantee mechanism programme, the structure of the securitisation, and certain terms of the notes and the NPL guarantee (the "NPL Guarantee"). Secondary legislation to be adopted within 60 days may make further provisions relating to the guarantee.

1. Scope and transaction structures

The Italian Ministry of Finance ("MoF") shall issue NPL Guarantees from the date on which the law enters force until a date eighteen months from then (and for a further 18 months if so approved by the European Commission). NPL Guarantees only apply to senior tranches of securitisation notes issued by Italian securitisation vehicles under Italian Securitisation Law (the so-called "Law 130").

The loans must be transferred to the SPV by an Italian bank for not less than net book value and must be classified as "non-performing".

The SPV must issue at least two tranches of notes (senior and junior) but may issue other mezzanine notes. In terms of subordination, the senior notes must rank in priority in point of principal to the other notes, but mezzanine may rank in priority to the senior notes in point of interest only (although it is not clear whether this priority also applies upon enforcement). Liquidity facilities are permitted to smooth the transaction cashflows.

The loan servicer ("NPL Servicer") must be a third party with respect to the originator bank and its banking group. If the NPL Servicer is the same as the Law 130 Servicer then it must be enrolled in the register of financial intermediaries under Article 106 of the 1993 Italian Consolidated Banking Act. Any substitution of the NPL Servicer must not impair the rating of the senior notes.

2. Terms and Conditions of the notes

The senior notes must be floating rate and the coupon on the mezzanine notes may be conditional on performance or deferred. Pre-payments are permitted out of net cashflows.

3. Priority of Payments

Article 7 of the Law Decree sets out the following priority of payments:

- taxes;
- payments to service providers;
- fees and interest under the liquidity facility;
- NPL Guarantee payments;
- swap payments;
- interest on the senior notes;
- principal on the liquidity facility;
- interest on the mezzanine notes;
- principal on the senior notes;
- principal on the mezzanine notes;
- payments on the junior notes.

The NPL Servicer is paid outside the waterfall as a "pre-deduction".

4. NPL Guarantee

4.1 Conditions for grant

NPL Guarantees will be issued by the MoF following receipt of a written application by the originating bank.

The NPL Guarantee covers only the senior tranche and covers all amounts contractually due until repayment.

The NPL Guarantee will be effective only where the bank sells at least 50% of the junior notes and a sufficient portion of any mezzanine notes and the junior notes to achieve de-recognition of the NPLs.

A further condition of the NPL Guarantee is that the senior notes are rated investment grade (i.e. Baa3/BBB-/BBB-/BBBL) by at least one ECB-approved external credit assessment institution (ECAI) being DBRS, Fitch Ratings, Moody's and Standard & Poor's. Any second rating agency used (which would also have to rate the notes investment grade) may be a rating agency in the approved ESMA list Regulation 1060/2009.

If the rating is private then the Italian Ministry of Finance must approve such agency in addition to the ECB.

The MoF may subject to European Commission consent, appoint a qualified third party to monitor compliance with the guarantee rules.

4.2 Premium

The cost of the guarantee will reflect market rates and be based on the price of credit default swaps ("CDS") for similar loans. The cost of the guarantee will step up over time:

i. the price for the first three years will be calculated as the average of the mid-price for three-year CDS for issuers with a rating corresponding to that of the guaranteed notes;

ii. the price for the fourth and fifth year shall rise due to the application of a first step-up (five-year CDS) and the payment of an additional incentive to offset the lower rate paid in the first three years;

iii. the price from the sixth year onwards will reflect the full price of the guarantee (seven-year CDS) and be further increased by an additional amount to offset the lower rate paid in the first five years.

4.3. Enforcement

In the event of non-payment of any guaranteed amounts, the Noteholders acting via the Representative of the Noteholders may call the guarantee. It would appear that individual Noteholders cannot enforce the guarantee.

Upon payment the MoF will be subrogated in the contractual rights of the Noteholders in relation to the recovery of amounts due, which shall include expenses and statutory interest from the date of payment to the date of repayment.

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