3.19 ITALY

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I. FRAMEWORK

The Italian Legislator enacted a new regulation (Law no. 80/2005) in May 2005, by means of which two specific articles (article 7-*bis* and article 7-*ter*) were inserted into the existing Italian securitisation law (Law no. 130/1999), providing for covered bonds.

The legislator decided to supplement Law no. 130/99 rather than adopt a separate and autonomous law/legal framework, in light of the markets' and international operators' positively assessing Italian securitization law. They found that the law introduced an established and reliable legal framework (e.g. from a standpoint of "bankruptcy remoteness").

Pursuant to paragraph 5 of the first of the two articles mentioned above, on 14 December 2006, the Ministry of Economy and Finance issued secondary rules in relation to some key issues of the structure. In particular, implementing rules have been enacted with respect to the type of assets eligible for the cover pool, the maximum allowed ratio between transferred assets and issuable securities, the type of guarantee to be provided to bondholders by the SPV.

As for the last procedural step, which formally allows Italian banks to start issuing covered bonds, the Bank of Italy enacted its implementing measures on 17 May 2007, in relation to the requirements to be complied with by issuing banks, the criteria to be adopted to evaluate the cover assets and the relevant formalities to integrate such assets, as well as the formalities to check that the banks are complying with their obligations under the same article 7-*bis*, also through auditors.

Under decree law 18/2016 article 13-bis, converted in law in April – law 49/2016 – the Italian legislator has set the compliance for "Obbligazioni Bancarie Collateralizzate" (OBC). This new instrument is a collateralised bond comparable with the European Secured Notes (ESN) for his structure – double recourse instrument – and since the nature of the eligible assets in the cover pool, mainly: SME loans, corporate bonds, aircraft loans and ship loans.

II. STRUCTURE OF THE ISSUE OF COVERED BONDS

Pursuant to the abovementioned article 7-*bis*, the structure of a covered bond transaction is as follows:

1. A bank transfers eligible assets to a special purpose vehicle (SPV), whose sole corporate purpose is the purchase of such assets and the granting of a guarantee for the issued securities over which bondholders have a senior claim;
2. The SPV purchases the transferred assets by means of a loan granted or guaranteed to it by a bank (not necessarily the same bank transferring the assets);
3. The bank transferring the assets (or another bank) issues covered bonds;
4. The assets purchased by the SPV are applied to satisfy the rights attaching to the covered bonds and the counterparties of derivative agreements entered into for hedging the risks related to the assets, and to pay the costs of the transaction.

According to the Bank of Italy's regulation, covered bonds can be issued only by banks with the following prerequisites:

> Own funds not lower than EUR 250 mln;

> A total capital ratio not lower than 9%.

It is also provided that these requisites must be fulfilled by the transferring banks as well (i.e. cover pool providers), if they are not the issuers.

There are no business restrictions to the issuer's activity, hence there is no special banking principle that needs to be enforced. Bondholders hold a preferential claim on the cover assets and the covered bonds are direct, unconditional obligations of the issuer.

III. COVER ASSETS

As provided for by paragraph 1 of Article 7-*bis* of the securitisation law, the eligible assets as coverage for covered bonds are:

a) Residential mortgage loans with a maximum LTV of 80% or commercial mortgage loans with a maximum LTV of 60%;

b) Claims owed by (or guaranteed by) the following entities, up to 10% of the cover pool:

> public entities of EEA member countries and Switzerland with a maximum risk-weight of 20%;

> public entities of non-EEA member countries with a risk weight of 0%;

> other entities of non-EEA member countries with a risk weight of 20%.

c) Notes issued under a securitisation transaction backed (for a minimum of 95%) by the claims under the abovementioned letters a) and b), that qualify for the credit quality step 1 under the Standardised approach. In case the covered bonds are backed by notes issued under a securitisation transaction for more than 10% of the issuance nominal value, the following additional conditions must be fulfilled:

> the residential or commercial mortgage loans must have been originated within the banking group of the issuer;

> the issuer or an entity consolidated in the same banking group holds the risk underlying the entire junior tranche;

> the issuer and the SPV are able to verify, on an ongoing basis, the eligibility and the volumes of the securitised assets and to provide the asset monitor with all the relevant information it may require to perform its controls.

As regards the transferring of such eligible assets to the SPV, the Bank of Italy sets different limits according to the different regulatory capital levels of the issuer (see Figure 1).

> FIGURE 1

Regulatory capital level		Transfer limitations
Class A	Tier 1 ratio ≥ 9% and Core Equity Tier 1 ratio ≥ 8%	No limitations
Class B	Tier 1 ratio ≥ 8% and Core Equity Tier 1 ratio ≥ 7%	Eligible assets can be transferred up to 60% of total
Class C	Tier 1 ratio ≥ 7% and Core Equity Tier 1 ratio ≥ 6%	Eligible assets can be transferred up to 25% of total

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, assets must have at least equal liabilities, both on the nominal and NPV bases, and the revenues arising from cover assets must be sufficient to pay coupons to bondholders and to cover the cost of derivative transactions.

The integration of cover assets can be performed through:

1. the transfer of additional eligible assets to the pool;
2. the opening of deposit accounts at banks located in an EEA member country, or in other countries with a 0% risk-weight;
3. the transfer of banks' own debt securities (with maturity of less than 1 year) to the pool.

It is also provided that integration through assets under points 2 and 3 is allowed only up to 15% of the cover pool's nominal value. With respect to such provisions, the Bank of Italy established that integration is allowed only to:

> Maintain the ratio of issued bond to cover assets up to the abovementioned level provided for by the Ministry of Economy;

> In case of voluntary overcollateralisation, maintain the ratio of issued bond to cover assets up to the contractually-agreed limit;

> Respect the abovementioned 15% limit for eligible supplementary assets.

IV. ASSET-LIABILITY MANAGEMENT

In order to allow the SPV to fulfil its obligations, issuing banks are required to adopt proper asset-liability management techniques and to perform specific controls at least every 6 months, to ensure that the proceeds from the cover pool assets are always sufficient to pay the coupons on the covered bonds, and the overall cost of the transaction.

V. COVER POOL MONITOR AND BANKING SUPERVISION

As far as regulatory supervision is concerned, the Bank of Italy sets and monitors, on an ongoing basis, the abovementioned specific eligibility requirements for issuing banks which are stricter than those provided for traditional banking activities. These parameters require, in particular, own funds of at least €250 million and a consolidated total capital ratio of at least 9%. It is also provided that eligible assets may be assigned to the SPV only subject to a series of restrictions, graduated based on the total capital ratio and Tier 1 ratio at the consolidated level.

Although in some European countries the issuance of covered bond is subject to a "licence" granted by the Supervisory Authority upon the fulfilment of specific requirements, the Italian legislator has decided to make a different choice. Rather than introducing a "licence" system, it has defined a series of requirements and limitations to issuance which together can be *de facto* considered as the objective basis upon which to grant an issuance authorisation. Moreover, it must be considered that such requirements and limitations are in most cases stricter than those required by other regulatory frameworks.

Furthermore, Italian regulation prescribes that the monitoring of the regularity of the transaction and of the integrity of the collateral securing investors must also be performed by an external asset monitor (AM) appointed by the issuer. The AM must be an auditing firm possessing the professional skills required to perform such duties and must be independent from the bank engaging it (e.g. it cannot be the same firm appointed to audit the accounts of the issuing bank) and of any other person participating in the transaction. It has to report at least once a year to the Board of Directors and to the internal audit department of the bank.

Although no specific reporting to the Bank of Italy is prescribed by law, in practice the AM will report to the Supervisor any material anomaly found. It must also be considered that the AM's report is reviewed by the bank's auditor which reports regularly to the Bank of Italy. Should such report contain negative evaluations, the bank's auditor is obligated to bring the issue to the Bank of Italy's attention.

In general terms, specific control requirements on banks issuing covered bonds find their primary source from EU and national legislation. Additionally, in consideration of the peculiarities of a covered bond transaction, the Bank of Italy assigns to issuers the primary responsibility to evaluate the risk involved in the operations, to arrange a proper control mechanism and to ensure its functioning through the time. In particular, at least every six months and for each operation, issuers have to check: i) the quality of the cover pool; ii) compliance with the predetermined ratio between outstanding covered bonds and cover assets; iii) compliance with transfer limitations and asset integration requirements; iv) the performance of any derivative agreement entered into in order to hedge risks.

As far as information flows are concerned, it is provided that issuing/transferring banks shall acquire, from all the parties involved in the structuring of the covered bonds, information relating to:

> the possessory titles of the transferred assets (in order to be able to track down each borrower whose loan has been transferred to the SPV);

> the performance of the transferred assets (in order to monitor the "health" of the cover assets).

This information is necessary to issuing/transferring banks in order to perform both the abovementioned controls in terms of cover pool monitoring and the regulatory reporting (i.e. reporting of defaulted loans to the Bank of Italy's *Centrale dei Rischi*).

VI. TRANSPARENCY

In 2012, the main Italian OBG issuers, coordinated by the Italian Banking Association, worked together to create a transparency template, consistent with the guidelines of the ECBC Label Initiative. The OBG transparency template is available online on the Covered Bond Label website (https://www.coveredbondlabel.com) and each participating OBG issuer has published a completed version on its own website.

VII. ASSET SEGREGATION AND IMPACT OF INSOLVENCY PROCEEDINGS ON COVERED BONDS AND DERIVATIVES

As provided for by the secondary legislation enacted by the Italian Ministry of Economy, the guarantee granted by the SPV to the covered bondholders, must be irrevocable, first-demand, unconditional and independent from the issuing bank's obligations on the covered bonds. It will be callable upon non-payment and bankruptcy of the issuing bank, and it will be limited to cover pool asset value to ensure bankruptcy remoteness of the SPV.

The SPV is a financial intermediary, registered in the "special list" provided for by article 107 of the Banking Law, and therefore subject to the Bank of Italy's supervision.

Covered bondholders will have the right, represented exclusively by the SPV, to file a claim with the issuing bank for full repayment of the covered bonds. In case of liquidation of the issuing bank, the SPV will be exclusively responsible to make payments to covered bondholders (as well as other counterparties) and will represent covered bondholders in proceedings against the issuing bank.

All the amounts obtained as a result of the liquidation procedure will become part of the cover pool and therefore used to satisfy the rights of covered bondholders. The redemption of the subordinated loan granted by the issuer of the covered bonds to the SPV is junior to any outstanding claims of covered bondholders, swap counterparties and transaction costs.

In case the proceeds obtained as a result of the liquidation procedure are insufficient to meet the obligations to bondholders in full, investors would still have an unsecured claim against the issuer for the shortfall.

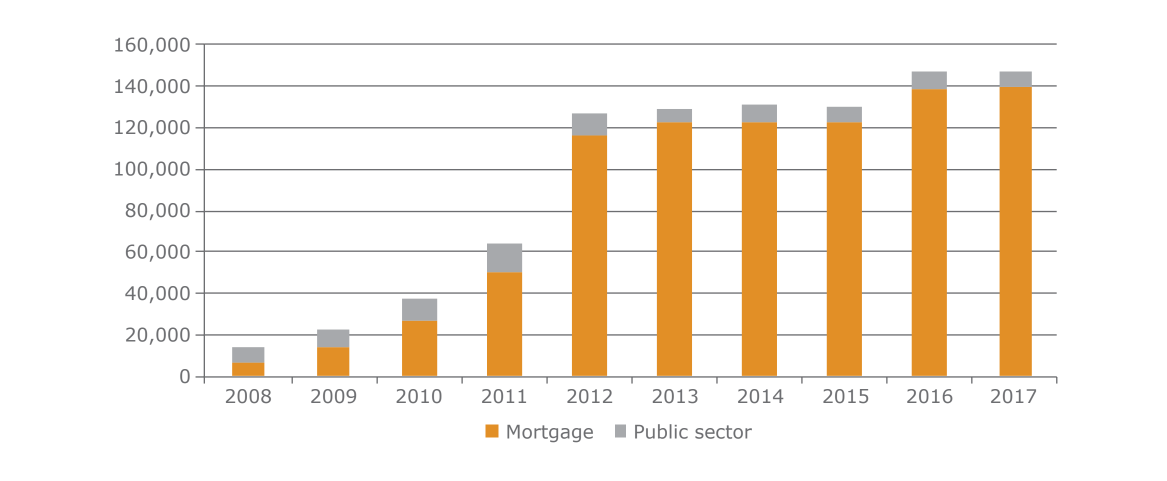
VIII. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 (7) of the Capital Requirements Regulation (CRR), also considered that a recent update of Bank of Italy's OBG regulation establishes that the asset monitor must verify, among other things, that the information disclosed to investor as per Article 129 (7) of the CRR are complete, accurate and provided in a timely manner. Italian covered bonds fulfil both the criteria of Article 52(4) UCITS and Article 129(1) CRR.[1] They are also eligible in repo transactions with the Bank of Italy.

The same compliance has been set for the "OBC".

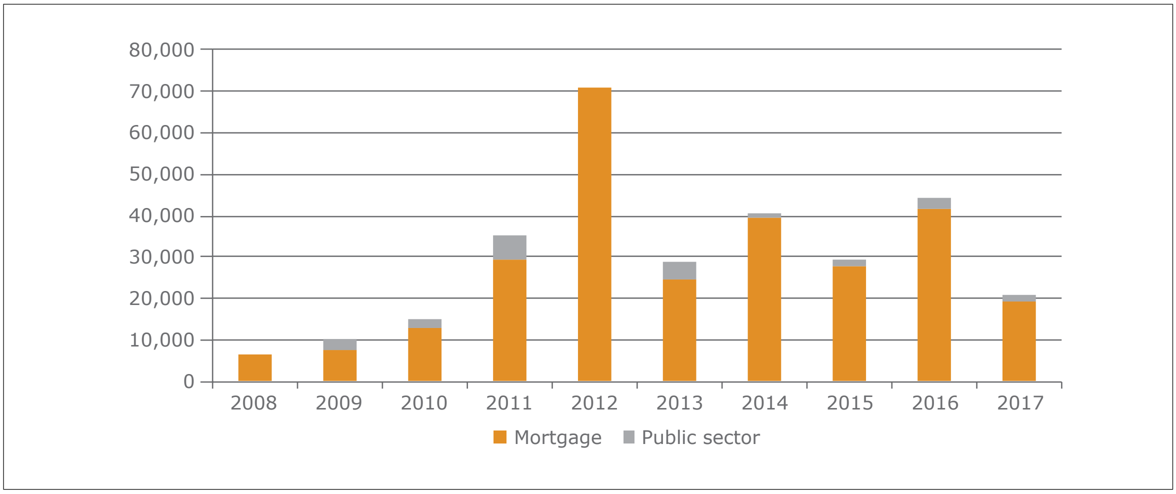
1 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): https://hypo.org/ecbc/covered-bonds/.

> Figure 2: Covered Bonds Outstanding, 2008-2017, EUR m



Source: EMF-ECBC

> Figure 3: Covered Bonds Issuance, 2008-2017, EUR m



Source: EMF-ECBC

Issuers: Unicredit, Intesa Sanpaolo, Banco BPM, Monte dei Paschi di Siena, Crédit Agricole Cariparma, UBI, Mediobanca, Deutsche Bank, Carige, Bper, Credem, Banca Nazionale del Lavoro.

ECBC Covered Bond Comparative Database: http://ecbc.eu/framework/31/Obbligazioni_Bancarie_Garantite_-_OBG.

Covered Bond Label: Banca Carige S.p.A. (1 pool), Intesa Sanpaolo S.p.A. (3 pools), UniCredit S.p.A. (2 pools), Crédit Agricole Cariparma S.p.A. (1 pool), BANCO BPM (1 pool).