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## Direct Lending in Italy

Opening the door  
for alternative lenders

2017



On 9 March 2017, Hogan Lovells hosted a panel discussion looking at the opportunities and challenges involved in direct lending in Italy. The speakers included experts with knowledge of the Italian market, who put forward their thoughts and shared their own recent practical experiences of doing deals in Italy. This article provides a summary of what was discussed in the session, as well as some further background on the market.

## New opportunities

Those of you who have worked on a leveraged loan by non-Italian lenders to an Italian business before 2012 will probably remember it as a rather painful experience, involving fronting bank structures to circumvent withholding tax exposure and the need for banking licences; complex security packages framed by a debtor friendly legal environment; and high registration taxes.

Happily, over the last few years, conscious that the stressed Italian banking system could no longer service all of the country's banking needs, the Italian Government has taken many steps to improve the ease of secured lending to Italian businesses. In particular, they have promoted the ability of alternative lenders to lend to Italian businesses and many issues which used to cause complexity have now been addressed.

## Overview of the changes

This metamorphosis started in 2012 with the Italian government recognising the need to diversify the sources of liquidity accessible by small and medium Italian enterprises (which represent the backbone of the Italian economy) but which had struggled to attract affordable investment from the debt markets. Between March and December 2012, Italy passed legislation to stimulate economic recovery which included the terms on which commercial paper and debt securities could be issued by non-listed businesses and the introduction of tax incentives to both issuers and investors. These new rules facilitated, for example, the issue of tax efficient "mini bonds" (debt notes issued by SMEs), subordinated and profit

sharing debt securities, and commercial paper having a maturity of up to 36 months<sup>1</sup>. These securities could be issued in excess of the statutory quantum limitations applicable to commercial companies<sup>2</sup>, provided that the notes are listed on a regulated exchange or multilateral negotiation system.

The main breakthrough took place in 2014, when Italy passed laws<sup>3</sup> to allow lending by investment funds, insurance companies<sup>4</sup>, SACE S.p.A. (Italy's Export Credit Agency) and securitisation SPVs. In 2015, the Ministry of Finance<sup>5</sup> and the Bank of Italy<sup>6</sup> published detailed rules for debt funds engaging in lending. In the same year, Italy passed rules to streamline enforcement and insolvency proceedings, and stimulate and sustain the supply and demand for non-performing loans (NPL's)<sup>7</sup>. Previously the Italian NPL market struggled as a result of staggered tax deductions for debt write-offs and lengthy, inefficient debt recovery proceedings.

The latest steps were taken last year, specifically to facilitate loans origination by foreign debt funds. The Government supplemented the Finance Act<sup>8</sup> to clarify that EU AIFs can make loan investments subject to certain conditions and limitations.

The most significant rules from an alternative lender perspective are those which have been designed to enable alternative lenders to provide direct lending to non-consumers, both through the implementation of the EU's AIFMD legislation in Italy and as a result of local law change which has eliminated some of the previous legal uncertainties which had existed.

1 Law decree No. 83 of 22 June 2012, converted by law No. 134 of 7 August 2012, and law decree No. 179 of 18 October 2012, converted by law No. 221 of 17 December 2012.

2 For S.p.A.s, two times the sum of corporate capital, statutory reserves and available reserves as shown in the latest approved financial statements. This limitation does not apply to S.r.l.s, their debt notes can only be subscribed or purchased by the issuer's shareholders, or 'professional investors subject to prudential supervision'.

3 Law decree No. 91 of 24 June 2014, converted by law No. 116 of 11 August 2014.

4 IVASS Regulation No. 22/2014.

5 Ministry decree No.30 of 5 March 2015.

6 Regulation on collective management of savings, 19 January 2015.

7 Law decree No. 83 of 27 June 2015, converted into law No. 132 of 6 August 2015).

8 Law decree No. 18 of 14 February 2016, converted into law No. 49 of 8 April 2016.

On 23 December 2016, the Bank of Italy supplemented the regulation on collective management of savings to specify the procedure and conditions for EU AIFs to grant direct credit in Italy and to purchase Italian debt, by applying to the Bank of Italy for clearance. Both Italian AIF's and EU AIF's are subject to the Italian Transparency Rules which apply to banks and financial intermediaries when lending to Italian businesses.

Broadly speaking, in implementing these changes the Bank of Italy has followed the EU rules taking into account ESMA's view<sup>9</sup> that shadow banking needs regulation because it raises systemic risk<sup>10</sup>. Also, some useful clarification emerged during consultations arranged by the Bank of Italy on the new rules, the account of which were published in December 2016. Accordingly, to lend in Italy EU debt funds:

- must be a closed-end EU AIF, authorised in its home jurisdiction to carry out lending, and adopt an operation scheme (in particular with respect to investors' participation in the fund) similar to that adopted by Italian debt funds;
- have to apply to the Bank of Italy and refrain from engaging in lending for 60 days following the application;
- must abide by the restrictions applicable to Italian debt funds, including:
  - concentration, as each AIF cannot invest more than 10% of its total assets<sup>11</sup> in credit to any given borrower or corporate group;
  - leverage, which cannot exceed 30% (for retail funds) or 150% (for reserved funds), in each case in respect of the AIF's total assets;
  - the maturity of any loans granted cannot exceed the life of the AIF;
  - retail funds can only enter into derivatives for hedging purposes;

- must accede to the Bank of Italy's central credit information system (*Centrale dei Rischi*) directly, or through a bank or licensed financial intermediary;
- must be managed pursuant to internal credit risk management systems of the relevant AIFM.

While the new rules clearly signal a step change in the Italian approach to alternative lenders, a few of the requirements in the authorisation process imply that, to be authorised to lend in Italy, EU AIFs must be expressly licensed (i.e. not just generally permitted) in their home jurisdiction. Also, a few of the lenders' key questions in this area have remained unanswered:

- the fact that an EU AIF is authorised to lend in Italy does not mean that it can do so via a wholly owned SPV, as the regulatory requirement must be fulfilled for the specific legal entity acting as lender;
- the purchase of receivables for consideration remains a regulated activity, and it is questionable whether debt funds which are not authorised in Italy as described above are permitted to acquire loans in the secondary market;
- the Bank of Italy has not addressed the question of fronting bank structures, and it is likely that these will remain attractive for debt funds that do not intend to file for clearance with the Bank of Italy;
- Italian and foreign AIFs are unlikely to qualify as 'professional investors subject to prudential supervision' for the purposes of subscription or purchase of debt notes issued by Italian corporates.

<sup>9</sup> ESMA opinion of 11 April 2016, 'Key principles for a European framework on loan origination by funds', ESMA/2016/596.

<sup>10</sup> See the Bank of Italy's 'Shadow banking out of the shadows: non-bank intermediation and the Italian regulatory framework', Occasional Paper No. 372 of February 2017.

<sup>11</sup> This condition is lifted for the first six months from start of the AIF's operations. For AIFs reserved to qualified investors, the total assets are calculated taking into account investor commitments.

<sup>12</sup> Politecnico di Milano, Osservatorio Mini-Bond, 3rd Report on Mini-Bonds, February 2017.



## Current alternative lender transaction structures

Whilst the Italian Government has been keen to introduce liquidity supplied by alternative lenders to benefit Italian businesses, the Italian loans market is still focused predominantly on Banks but there are lots of indications that this is about to change and that it will be an advantage to be an early mover.

The alternative lender market in Italy has grown significantly recently since the first deals done by debt funds back in 2013 (which originally used Luxco structures to provide a simpler enforcement environment).

Whilst most lenders focus on investing in loans, mini-bond structures have also been adopted particularly as the enforcement procedure for commercial paper is very favourable to investors. According to the Technical University of Milan<sup>12</sup>, over the last 4 years €12 billion of mini-bonds and commercial paper have been issued by 292 issuers. 28% of investors in mini-bonds are institutional investors so this is not simply a domestic investment product. Mini-bonds do have the significant limitation that it is difficult to increase the facility should the business need additional investment.

Turning back to loans, one of the difficulties for alternative lenders is that they are usually not able to provide working capital facilities (such as revolving credit facilities or overdrafts) to a business. Currently, unlike seen in the UK, there is little collaboration whereby debt funds provide term debt and Italian banks provide working capital facilities to an Italian business. This seems to be because banks still see the debt funds as competitors rather than as a source of future transactions. There is no legal reason why this sort of arrangement should not be consummated though if the parties have the conviction to work together to document it and there are many commercial reasons why this does make sense. This sort of collaboration is thought to be most viable for €25 million plus EBITDA businesses (as the banks currently hold the lion's share of the market to meet the needs of smaller businesses).





### Is the opening likely to come first from a private equity sponsor-backed deal?

In our experience sponsors are now asking whether an alternative lender loan structure is an option for new deals as they have seen how debt funds and banks have clubbed together on UK deals. The cultural barriers are being broken down. Ultimately it will be an economic decision as to whether a unitranche type structure would work for the sponsor's IRR on a particular credit if the traditional bank loan model was also available for the proposed deal. The extra  $x1/2$  to  $x1$  of leverage which direct lenders are often prepared to invest compared to a typical bank package may be an attraction. Also, in the debt funds' favour is that by going to them the sponsor avoids the need for market flex provisions, whereas Italian banks generally have strong take and hold requirements making syndication potentially costly and unpredictable.

Commentators have suggested that at this early stage of the direct lenders' entry into the Italian market, an easier source of deals could perhaps come from those businesses which present a more challenging credit risk, where the higher costs of direct lenders' facilities do not stand out as much when compared to the banks' pricing (if banks are even prepared to be supportive to that type of credit). Debt funds are also likely to find that if their pricing is more competitive on transactions requiring over €100 million of debt as the Italian banks generally have to charge more for that level of exposure.

### Tax changes

A couple of significant tax changes have helped to open up the loans market.

First, withholding tax is no longer an issue if certain conditions are complied with and that change extends not only to banks but to alternative lenders too. Indeed, whilst prior to June 2014 all foreign lenders were subject to Italian withholding tax, now European banks, EU insurance companies subject to supervision in their home countries and white list resident institutional investors (such as AIF, UCITS or pension funds) can benefit from a full withholding tax exemption, provided that they are authorised

to lend in Italy. Non EU banks (and debt funds which do not file for clearance with the Bank of Italy) remain subject to Italian withholding and may be lead to structure their lending activities through fronting bank structures. The Italian tax authorities, however, have become more familiar with reviewing<sup>14</sup> such structures and will normally challenge them whenever the Italian (or now EU) fronting bank qualifies as a mere interposed entity.

Stamp duties, particularly where a transaction entails real estate security, can be very expensive. However, the substitutive tax regime (replacing the ordinary stamp duties with a 0.25% charge on the facility amount, irrespective of how many guarantees and security documents are put in place as part of that transaction), which was once available only to banks, is now open also to medium/long term loans made by Italian securitisation vehicles, EU authorised insurance companies and collective investment funds established in the EU or in white list EEA countries.

Moreover, the scope of application of the substitute tax regime has been substantially widened as to cover also the subsequent transfer on the secondary market of the contracts and receivables (plus associated security package) arising from medium/long term loans on which the original parties mandatorily paid or – since 2014 – elected to pay duty under the substitute tax regime, meaning that the subsequent transfer is now fully tax exempt.

The syndication and transfer on the secondary market of medium/long term loan agreements and receivables thereof, either performing or not, is therefore now appealing to both Italian and foreign lenders due to the full exemption from both documentary taxes (provided that the original loan were subject to the above substitutive tax charge) and withholding tax (provided that the transferee of the loan/receivables meets the subjective requirements mentioned above).

## Security changes

Whilst this article has concentrated on how alternative lenders may be able to compete in the Italian loans market, it is worth noting that all types of lenders are able to benefit from the Italian law revisions made to the security regime recently. One example is the *pegno non possessorio*, a new form of Italian security which consists of a non-possessory pledge over certain types of moveable assets (present and future) and credits used for business purposes (basically machinery and raw materials). Another is the real estate conditional security assignment agreement (*Patto Marciano* agreement) which allows security over real estate assets to be appropriated out of court by lenders<sup>13</sup>.

These instruments should prove helpful in a country where enforcement of security tends to be a lengthy and court administered process.

## Key advice for new entrants

European debt funds are looking outside of the UK towards potentially less competitive markets. Could Italy become a good destination? The Italian market is certainly not as crowded as the UK or the Nordic markets but it is changing quickly. Generally, documentation terms (which are based on the LMA standard form leveraged credit agreement as updated for Italian law) are currently not as aggressively pro-borrower as they are in other parts of Europe. Italy is not the most straight forward of jurisdictions in which to lend but with careful structuring and tax advice the consensus is that there are opportunities for alternative lenders who are prepared to invest the time to get to know the markets and to build relationships with sponsors, banks and Italian businesses.

## March 2017

<sup>13</sup> Both new types of security were introduced by law decree No. 59 of 3 May 2016, n. 59, converted by law No. 119 of 30 June 2016.

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