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SECURITISATION WITHOUT SECURITIES: NEW FUNDING STRUCTURES AVAILABLE TO ITALIAN SECURITISATIONS

At the end of 2020 we witnessed another milestone in the fast-evolving history of the Italian Securitisation Law,[1] an innovation which is likely to have a long-lasting impact on how Italian securitisations will be structured from now on, and to improve their ability to better adapt to the ever-changing needs of the market. The 2021 Budget Law[2] has introduced an alternative funding tool for Italian securitisation vehicles (or SPVs) alongside the traditional asset-backed notes (the "**Notes**"). SPVs may now fund their securitisation transactions also through the proceeds of *ad hoc* financing advanced by entities who are licensed to grant loans in Italy (the "**Alternative Financing**"). This Square The Circle is intended to collate our thoughts on this new tool and to explore its likely uses.

What the New Tool is

The approach followed by the Italian legislator in devising this new regime is twofold. On the one hand, it has specified very few features that the Alternative Financing has to have, while, on the other hand, the residual part of its regime will have to be derived, *per relationem*, from the provisions (where compatible) of the Italian Securitisation Law dealing with Notes. As one could imagine, this technique leaves significant room to interpretation.

Starting from what is known with certainty, the Alternative Financing has the following characteristics:

a) the financing must have a specific purpose, *i.e.* to provide to the SPV the funding necessary to acquire the assets to be securitised (which traditionally has been achieved through the issuance of Notes);

b) the financing can only be granted by certain financiers, *i.e.* those who are licensed to grant loans in Italy (in other words, Italian banks, Italian financial intermediaries, EU banks, non-UE banks authorised by the Bank of Italy, and subject to certain restrictions, Italian and EU insurance companies, Italian credit funds, and EU credit funds).[3]

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[1] Law no. 130 of 30 April 1999.

[2] Law no. 178 of 30 December 2020.

[3] With regard to credit funds, lately they have been rekindling the investors' appetite in light of the recent removal of the investment concentration's limit once applicable to reserved alternative investment funds. On 16 February 2021, the Bank of Italy updated its regulation on funds and fund managers ("*Regolamento sulla gestione collettiva del Risparmio*") to remove the concentration limit of 10% applicable to reserved credit funds. However, we understand that in a recent ruling rendered by the Bank of Italy, the national supervisor appears to have taken the view that credit funds cannot invest in securitisation transactions (either via subscribing notes or, now, advancing loans) whose underlying portfolio is comprised of consumer loans. This approach would mirror, in the Bank of Italy's view, the express exclusion of the ability to directly advance loans to consumers contemplated by the law (articles 46-bis ff. of the Italian financial act).

Based on the requirement referred to in b) above, it appears that the Alternative Financing cannot be granted by unlicensed entities who would be nevertheless allowed to provide financing in specific circumstances under certain exemptions contemplated by Italian law (for example, intragroup companies). This means, in turn, that Notes remain the only way for unlicensed investors to provide funding to SPVs (including where the investor holds a stake in the relevant SPV).

Little is known, instead, as to what other characteristics the Alternative Financing must or may have. Absent any specific indication, the law may seem to allow the parties a great freedom in deciding how the tool should be structured in practice. However, by looking at the matter more closely, it appears immediately clear that, when selecting the contractual instrument to be used in practice, two possible options would in principle exist.

On the one hand, one could be drawn to believe that, by referring to the concept of "*finanziamento*" (financing) and by requiring that the Alternative Financing be granted by entities who are licensed to grant loans in Italy, the Alternative Financing should be structured as an interest-bearing financing. On the other hand, the rationale for limiting the Alternative Financing to this type of transaction is not clear. Should a more liberal view encompassing any type of contractual funding scheme not incorporated in securities, prevail, the Alternative Financing could not only be a loan, a committed credit facility (*apertura di credito*), a revolving facility,[4] but also a non-debt instrument such as a sub-participation or a total return swap.[5] Following such approach, the parties would be better placed to craft contractual arrangements allocating risks and benefits in a more flexible way, able to cater to a wider range of commercial agreements.

In any case, where this is not already a typical feature of the specific tool chosen, the Alternative Financing should incorporate a limited recourse mechanism to support the bankruptcy remoteness of the SPV.

Other Forms of Financing in Securitisation Transactions

The possibility for SPVs to access funding via loans is far from being a novelty *per se*.

Ancillary financings have been traditionally included in more evolved securitisation structures to deal with the liquidity risk associated with the disruption or unpredictability or the collection/recovery timing of the underlying securitised assets, via liquidity facilities or subordinated loans funding from the outset the creation of reserves.

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[4] Careful thought should be given as to whether any such financing could benefit from security, due to the somewhat uneasy interaction between the security and the segregation of the SPV's assets by operation of law.

[5] In this respect, it may be noted that, when dealing with the securitisation by way of financing under article 7(1), the Italian Securitisation Law contemplates, in paragraph 2-novies of that article, the possibility that the SPV receive through a "*finanziamento*" (financing) granted to the originators all the collections generated by the securitized claims. In this case, the Italian Securitisation Law seems to be open to a quite wide notion of "*finanziamento*" (financing).

While the purpose of the Alternative Financing is very different from that of such liquidity facilities or subordinated loans, things may get more complicated when comparing the new tool with another form of financing that has been largely used in the past and which is now a well-established instrument in the Italian market, *i.e.*, the so-called limited recourse bridge loans. Such loans are normally granted to SPVs, at the early stage of the transactions, by the prospective subscribers of the Notes as an advance payment, often partial, of the subscription price of the Notes, in order to fund the purchase price of the assets to be securitised, and are intended to remain in place only for a limited period of time (that is as long as necessary for the all the activities required for issuance of the Notes to be completed).

Whereas there is little doubt that the Alternative Financing and a limited recourse bridge loan achieve the same objective, *i.e.*, providing to the SPV the funding required for the acquisition of the assets to be securitised, the two instruments seem to diverge from one another on one critical point. One of the key features of the limited recourse bridge loan is that it is temporary as it is intended to be refinanced through the proceeds of the issuance of the Notes at the end of the "bridge phase". Conversely, the Alternative Financing (like the Notes) is meant to be a stable funding arrangement for the SPV (which, in other words, is not legally required to be converted into something else).[6] In conclusion, as they serve different purposes, these two tools should not be confused with one another nor should the limited recourse bridge loans be subject to the regime applicable to the Alternative Financing.

In addition, the regime on Alternative Financings should not interfere with the possibility, in a dual-SPV securitisation structure, for the SPV receiving funding from the market to advance a limited recourse loan to the SPV holding the assets to be securitised.

Alternative Financing and Notes

Alternative Financings have the potential to be more flexible and versatile than the Notes.

Unlike dematerialised Notes, the Alternative Financing will not require the involvement of any indirectly holding system (such as Monte Titoli, Euroclear or Clearstream), with all associated savings in terms of time, costs, and operational complexities.

However, as pros come with cons, Alternative Financings will be less tradable instruments than Notes in terms of trading facilities, reference market and legal requirements associated with the transfer.

[6] In our view, however, such stability does not imply that, in turn, the Alternative Financing cannot be refinanced, via another contractual funding schemes or notes, on a later stage during the life of the transaction.

Although syndication of Alternative Financings will benefit from the new possibilities offered by fintech,[7] Notes can be listed and traded on regulated markets and multi-lateral trading platforms, which should ensure, at least in principle, greater liquidity for these types of instruments.

In addition, while Notes may be transferred among "qualified investors" (which captures a quite wide range of investors), due to lending being a reserved activity in Italy, the pool of possible transferees of Alternative Financings will be limited to licensed lenders (in the meaning outlined above).

Furthermore, dematerialised Notes can be transferred by a simple and straightforward instruction (of delivery versus payment or delivery free of payment) given by the owner/account holder to its depository bank. Conversely, a transfer of Alternative Financing may be quite a complicated transaction, involving compliance with various perfection formalities, depending on whether the receivables deriving from the Alternative Financing or the underlying contractual relationship are being assigned.[8]

In terms of governance, an Alternative Financing structure may entail a shift from a corporate-like governance rules to a syndicated loan agency model (where the intercreditor arrangements will become pivotal).

Tax Considerations

Although Alternative Financings and Notes are subject to different tax regimes, in many instances the tax analysis is likely to lead to a similar practical outcome (that is, exemption from withholding tax in Italy), especially where the Alternative Financing is to be considered an interest-producing debt instrument.

In case of Notes held by non-Italian residents, interest payments are exempted from the 26 per cent. substitute tax (*imposta sostitutiva*) provided that the holders of the Notes are the beneficial owners of the relevant income and are resident, for tax purposes, in a country which allows an adequate exchange of information with the Italian tax authorities – so-called white list jurisdictions.[9]

As to loans, interest payable by Italian companies to Italian lenders would not be subject to withholding in Italy.

[7] See, for example, Blockinvest at https://www.blockinvest.it/, a marketplace specifically designed for financial institutions and market operators trading in illiquid investments in alternative assets, who wants to benefit from the flexibility and security of the blockchain technology via token exchange.

[8] As a matter of Italian law, such perfection formalities may encompass, among others, the transfer being notified to the debtor by an instrument bearing date certain at law, or the counterparty expressly accepting the assignment of the contract to the transferee.

[9] See Decree of Ministry of Economy and Finances no. 239/1996, as amended and supplemented from time to time every six months.

Interest paid by Italian companies to non-Italian resident lenders are ordinarily subject to withholding tax at the domestic rate of 26%, subject to (a) applicable reductions under the relevant tax treaty between Italy and the country of tax residence of the relevant lender, where applicable or (b) applicable exemptions where the conditions for the EU Interest and Royalty Directive[10] are met.

In addition, Italian law provides for a withholding exemption regime on interest under medium-long term loans (*i.e.* with a maturity exceeding 18 months) paid to (and beneficially owned by):

a) banks established in a EU Member State (or EU permanent establishment of non-EU banks);

b) insurance companies established in a EU Member State and authorized under the legislative provisions of a EU Member State;

c) non-Italian institutional investors established in a State or territory allowing for an adequate exchange of information with Italy, provided that they are subject to forms of regulatory supervision in their home country; and

d) certain quasi-sovereign lending institutions.

The above exemption applies subject to the relevant lenders being authorized to perform lending activities towards the public according to the Italian law.

For the sake of completeness, please note that, given the innovative nature of the Alternative Financing, the application of the exemption of interests on such loan would need to be investigated in greater depth considering the specific circumstances to assess whether all relevant requirements are satisfied.

In case of Alternative Financing legally categorised as a derivative, the tax analysis on the relevant remuneration will be driven by the specific features of the instrument since the tax status could diverge from the legal one and could be qualified in some cases as an atypical security.

Final Remarks: Possible Applications and Open Points

Based on all the above considerations, we predict that Alternative Financings will be used in many scenarios (including where frequent or unpredictable or immediately available funding is a necessity). These will include the use of Alternative Financings:

a) in the warehouse phase of securitisation transactions, during which SPVs build up their stock before going to the market through the issuance of (possibly rated) Notes;

[10] Directive 2003/49/EC.

b) as a refinance tool in the context of existing transactions, in line with the market practice contemplating the early redemption of the Notes (for optional redemption, redemption for tax reasons, clean-up calls, etc.) via alternative funding structures including limited recourse loans by licensed lenders; and

c) as senior vendor loans advanced by banks in the context of the securitisation of their own NPL stock (whether achieving derecognition or not), in conjunction with the new risk weight rules applicable to the senior tranches of NPL securitisations recently approved by the European Parliament.[11]

Additionally, it is likely that Alternative Financings will become a common feature for the senior tranches of so-called real estate securitisations under article 7.2 of the Italian Securitisation Law. The fact that real estate financing is traditionally one of the sectors of choice for Italian banks seems to point in this direction.

Uncertainty exists at present as to whether a transaction may be implemented via both the issuance of notes and the advancing of Alternative Financings. Should a more liberal interpretation, allowing such combination, prevail, the parties would be better placed to calibrate the investment in terms of funding requirements, preserving the instrument better suited to each investor involved.

One last point concerns the scope of the Alternative Financings. As specified at the beginning, the new tool is meant to provide funding for the acquisition of the assets to be securitised. However, the law does not specify whether the Alternative Financings may be used also to fund other costs associated with the securitisation. Based on a simple parallelism with what happens in practice with the Notes, the likely answer to the question is that the proceeds of the Alternative Financing can indeed be applied to fund acquisition costs, reserves etc. The answer, however, may be less clear-cut when dealing with capital expenditures and operational expenditures in the context of real estate securitisations under article 7.2 of the Italian Securitisation Law. The matter is deeply intertwined with the issue of the extent of the interventions that this type of SPV may carry out on the underlying real estate assets, which is currently a hot topic in the discussion of scholars and practitioners alike, where widely differing interpretations are being put forward. In our view, the Alternative Financing could be used to fund only those capital expenditures which fall within the scope of the activities that the SPV is entitled to perform over the real estate assets without stepping outside the boundaries of a securitisation under article 7.2 of the Italian Securitisation Law.

[11] See also our Square The Circle of September 2020, "Emerging a New Dedicated EU Regulatory Regime for NPL Securitisations?".

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