

BANK OF ITALY PROVIDES OPINION ON PROPOSED REFORM OF ITALIAN NPLS

In September 2018, a group of senators belonging to the conservative area (today in opposition to the current government) submitted to the Italian Parliament a draft bill¹ regarding certain drastic measures intended to support the recovery of bad loans (*crediti in sofferenza*) and promote the reperforming process of debtors (the "**Draft Bill**"). The Draft Bill, which is currently under discussion in the Senate together with other measures regarding NPLs, intends to introduce an option right for debtors to settle with their creditors at pre-determined terms.

As part of the legislative process, the Bank of Italy has been requested to provide its opinion on the proposal and, on 18 March 2020, a paper was released by the domestic regulator (the "**Bankit Paper**").

The Proposal

In broad political terms, the goal of the Draft Bill is to bring distressed debtors back to performing status.

In a nutshell, the proposal can be summarised as follows:

- o **Scope of the new regime:** The Draft Bill will apply to:
 - receivables classified as non-performing (*crediti deteriorati*)² between 1 January 2015 and 31 December 2018, being assigned by banks and financial intermediaries to third parties (including securitisation vehicles); and
 - debtors being individuals or corporates qualifying as micro-enterprises or SMEs, provided that the gross book value of the overall debt of each individual debtor *vis-à-vis* the single creditor does not exceed Euro 25 million.
- o **Option Right:** Under the new rules envisaged by the Draft Bill, debtors will have the right to discharge, at their sole discretion, by way of payment of a settlement amount equal to the purchase price paid by the third-party assignee plus a 20% margin.

The aforementioned purchase price will be determined on the basis of the ratio between gross book value of the relevant receivable and the consideration paid for the overall portfolio in which the receivable is included.³

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¹ Draft Bill no. 788 (*Disposizioni volte ad agevolare le prospettive di recupero dei crediti in sofferenza e a favorire e accelerare il ritorno in bonis del debitore ceduto*).

² In this respect there seems to be some disconnect with the title of the Draft Bill, which refers to "bad loans" (*sofferenze*).

³ This formula is quite unclear. Where it is meant to determine the individual purchase price as a percentage of the aggregate purchase price of the portfolio based on the ratio between the gross book value of the receivable concerned

ITALIAN LEGAL SERVICES Ltd.

Registered number: 10845650. Registered Office: 3 Ravey Street | London EC2A 4QP | United Kingdom

Head Office: Eagle House, 167 City Road | London EC1V 1AW | United Kingdom

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- o **Mechanics:** From a procedural viewpoint, the Draft Bill provides that:
- the relevant assignor and the relevant assignee are obliged to notify the debtor of the assignment timely and in any case within ten days of the assignment;
 - the notice is required to specify the purchase price of the relevant receivables and to include the documentation giving evidence that the contents of the notice are complete and true;
 - in case of failure to comply with this notification duty, the assignor and the assignee cannot validly commence any enforcement or precautionary proceedings (*azioni esecutive e cautelari*);
 - the debtor will have to exercise the option by sending to the assignee a written notice to that effect within 30 days of the receipt of the assignment notice, by irrevocably committing to pay the settlement amount within 90 days or such other term as it may be agreed between the parties;
 - upon payment of the settlement amount the debtor is entitled to obtain the automatic removal of his or her name from the interbank credit bureau (*centrale dei rischi*).

The proposal is intended to apply also with respect to assignments of receivables carried out before the entry into force of the law (in which case the assignors will have to notify the debtors within 30 days of the adoption of the law).

Based on the Draft Bill, the logic behind the proposal seems to be that:

- a) third party purchasers have managed to obtain high returns on their investments, which should be returned to the debtors;
- b) selling banks have neglected settlement proposals submitted by debtors, giving preference to assigning the receivables to third party investors;
- c) investors have implemented aggressive recovery strategies which may affect the Italian productive system and households;
- d) by imposing settlements at lowered economic terms by law, debtors will increase their spending capacity, and this will translate in higher economic growth for the overall system.

and the gross book value of the overall portfolio, this is likely to cause great distortions (especially in case of mixed portfolios, including secured as well as unsecured exposures).



The Bankit Paper

In its paper, the Bank of Italy has expressed some criticism and concerns about the impact of the regime prospected by the proposal over the functioning of the NPL secondary market.

The domestic regulator's negative assessment of the proposal is based on the following arguments:

- a) **Excessive operational burden and uncertainty:** the notice mechanism represents an excessive burden on assignees, and it will generate great uncertainty about the assignment for a considerable amount of time;
- b) **Excessive measures:** the inability to commence enforcement or precautionary proceedings (*azioni esecutive o cautelari*) may have a significant impact on the economic return on the investment;
- c) **Discrimination:** debtors whose debt position is retained by originating banks (and, therefore, will not be entitled to the option right) will be discriminated against debtors whose debt position is sold to third parties;
- d) **Moral hazard:** the tool gives room to opportunistic behaviours by debtors (which, in turn, may result in a competitive disadvantage for the Italian market);
- e) **Retroactivity:** the inclusion of past transactions within the scope of the new regime will produce significant distortionary effects;
- f) **Regulatory ratios:** the Italian banks' ability to keep up with the improvement of their regulatory ratios will be adversely affected (even more if one considers the expected additional burden deriving on their balance from the Covid-19 crisis);
- g) **Negative impacts on NPLs secondary market:** the bid-ask gap in connection with the sales of Italian NPLs will likely widen again (with loss of the goodwill gained over the last few years).



Final Remarks

There are little doubts that new and (may-be) unprecedented measures are necessary in order to tackle the social and economic impact of NPLs in Italy. The problem is real, but the solution envisaged in the Draft Bill appears to be draconian and potentially able to generate advantages for debtors which are comparatively less significant than the harm caused to the overall Italian economy via the banking system.

One material risk is that the impact of the new proposed legislation will be factored by investors in their pricing and, therefore, they will be willing to pay less for Italian banks' NPLs (including those for which the relevant debtors are unable to take advantage of the new tool). This could have a dramatic impact on the ability of the Italian banking system to obtain external financial resources desperately needed to support profitable economic initiatives (especially at a time when macroeconomic trends – like the new green economy and the onshoring of business from overseas – will require a quick and profound transformation of the economic system).

In addition, we would like to spend a couple of words about the myth that the NPL business is a form of unjustified transfer of wealth to other countries. First, it should be noted that the market is comprised of a number of major domestic players (which, especially during the Covid-19 crisis, have been extremely active and are likely to be more so in the future). Second, the premium requested by investors in NPLs matches the high level of risk associated with these types of investments (not all of them have been fortunate and successful). Finally, by looking at the big picture, the wholesale of NPLs is obviously a much more efficient and appealing strategy for banks (whose institutional tasks is to provide credit to households and corporates) than managing thousands of individual relationships with troubled debtors.

Once the table is cleared of perhaps too simplistic or biased solutions, greater attention should be paid to initiatives mixing benefits for both parties in the settlement (the debtor, on the one hand, and the originating bank or third party buyer, on the other hand). In other words, the legal system should provide to them incentives to agree on arrangements allowing the debtor to have a fresh start, if successful, and give the creditor additional rights and tools which, in the opposite scenario, would make up for losses associated with a more indulgent recovery strategy adopted in the first place.



Contacts

For further information on the subject matter of this Square The Circle, please contact:

Norman Pepe – Partner

P: 44 (0) 203 617 6711

M: +44 (0) 771 734 3138

E: norman.pepe@italianlegalservices.com

Lorenza Talpo – Partner

P: 44 (0) 203 617 6712

M: +44 (0) 7789 982398

E: lorenza.talpo@italianlegalservices.com

Fabrizio Occhipinti – Partner

P: 44 (0) 203 617 6713

M: +44 (0) 792 058 8588

E: fabrizio.occhipinti@italianlegalservices.com