Hogan Lovells

Direct Lending in Italy

Moving into the mainstream?

2023

Direct Lending in Italy

Whilst stringent conditions continue to apply to debt funds which want to be authorised by the Bank of Italy to lend in Italy, in recent years alternative structures have gained momentum, leading to increased appetite from international and domestic investors.

Italy has been working to reduce its reliance on bank finance

For decades, the Italian loans market had been dominated by banks due to local regulatory requirements. The limitations of this model became evident during the global financial crisis in 2008 and the sovereign debt crisis in the mid-2010s.

Parliament took stock and kick-started a number of reforms in 2012 to diversify the sources of debt funding for Italian businesses. These reforms included improvements in the framework of debt securities and their tax treatment, and derogations (where notes are listed on a regulated exchange, or reserved for professional investors) from corporate laws limiting the maximum amount of permitted debt. Further reforms were passed to allow lending by investment funds, insurance companies, SACE S.p.A. (Italy's export credit agency) and securitisation SPVs.

Italy took a further step forward in 2016, introducing a regulatory pathway to facilitate loans origination by foreign debt funds, by supplementing the Finance Act[1] to clarify that EU alternative investment funds ("**AIFs**") can make loan investments subject to certain conditions and limitations. The Bank of Italy then supplemented the regulation on collective management of savings[2] to specify how EU AIFs could apply to the Bank of Italy for clearance to grant direct credit in Italy and to purchase Italian debt.

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. We have reported on these measures **here**[3], reflecting the ideas and concerns exchanged in a panel discussion on direct lending in Italy in March 2017.

The regulatory framework has continued to evolve

We discuss below a few more recent significant developments.

Direct lenders have increased their market share, with international debt funds taking the lead on innovative funding structures in specialised sectors such as infrastructure and real estate.

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

[2] The Bank of Italy's 'Regolamento sulla gestione collettiva del risparmio' of 19 January 2015

[3] **Link** to Direct Lending in Italy, April 2017 - Initial version

Italian investors have also taken stock and engaged in leveraged finance with increasing appetite and ticket sizes, especially in support of private equity sponsors.

With banks and traditional lenders challenged by the COVID-19 epidemic and the recent geopolitical events in Europe, opportunities for direct lenders are bound to increase further.

Obtaining clearance with the Bank of Italy to lend in Italy

The primary way for overseas AIFs to engage in lending in Italy (by granting credit directly or by purchasing existing loans, including any purchase in the secondary market) is to apply to the Bank of Italy for clearance. The process is less stringent than that required to authorise a domestic fund, and to be eligible for clearance a debt fund must:

- be structured as a closed-end EU AIF
- be authorised in its home jurisdiction to carry out lending, and
- must adopt an operation scheme (in particular with respect to investors' participation in the fund) similar to that adopted by Italian debt funds.

To be able to lend in Italy, in addition to applying to the Bank of Italy, all AIFs must also comply with a number of restrictions, including:

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

The initial version of the regulation included a limit on concentration, preventing debt funds from investing more than 10% of its total assets to any given borrower or corporate group.

While this particular limit did not apply for the first six months from start of the AIF's operations, it did curtail the interest from market participants and attract criticism from commentators. The concentration limit was removed[4] from the regulation in February 2021 and no longer applies.

Following the application, the fund must refrain from engaging in lending for 60 days. During this time the Bank of Italy can ask the applicant to supplement the documentation and information provided, in which case the 60 day period will run afresh. The Bank of Italy can reject the application during this time if it does not comply with the statutory requirements. If the application is not rejected within that time frame, then the application is successful and the fund can start to lend in Italy.

There is still a notable constraint on the ability of a debt fund to lend in Italy even if it is registered with the Bank of Italy. As all of the regulatory requirements must be fulfilled by the specific legal entity acting as lender, an authorised EU AIF cannot lend via a wholly-owned SPV.

Investing in debt notes and other debt securities issued by Italian corporates

In the search for sources of credit which could be utilised as an alternative to bank loans, much of the recent innovation has been directed at improving the conditions for the issuance of debt securities by Italian commercial companies. These reforms were intended to support SMEs against the backdrop of a recessionary economy by reducing the cost and complexity of this fundraising technique. Notes issued on the back of the reformed regime became known as 'mini-bonds', although many of the improvements in tax, corporate and available forms of security are equally available to mid-cap and large companies and for debt transactions of all sizes.

The most significant improvements are summarised below:

- The main improvement relates to the tax regime applicable to eligible non-Italian tax resident investors established in countries with an adequate exchange of information with Italy. These investors benefit from an exemption from Italian withholding tax in respect of interest and other income arising from debt notes and other securities issued by Italian corporates if those securities are either traded in an EU or EAA regulated market or multilateral trading facility or held by 'qualified investors'[5].

- Where the notes are secured, the issuer is entitled to opt for the application of a much cheaper special tax regime replacing the ordinary stamp, registration and other documentary taxes (for a land mortgage this would be 2-3% of the amount secured), with a one-off tax at 0.25% of credit in principal.

- In corporate law, joint stock companies are permitted to deviate from the usual

[4] Bank of Italy provision of 16 February 2021
[5] In the meaning of article 100 of legislative decree No. 58 of 24 February 1998 (the Italian Finance Act) and article 34-*ter*, first paragraph, letter b) of CONSOB Regulation No. 11971 of 14 May 1999

size limits in the issue of debt notes (being twice the aggregate of corporate capital and reserves), provided that the notes are traded in an EU or EAA regulated market or multilateral trading facility, or where they afford a right to convert the debt into shares of the issuer. The usual size limit will also not apply in respect of debt subscribed by professional investors[6] which are subject to regulatory supervision (*vigilanza prudenziale*) under special legislation applicable to them.

- Italian banking law was amended[7] to afford debt securities access to the 'special charge', a form of security otherwise reserved to qualifying bank loans. This type of security allows a creditor to charge the assets of a commercial borrower by registration in a ledger held by the court, without necessarily taking delivery or control of the collateral.

- The Italian civil code was supplemented[8] with respect to the issuance of secured notes, to allow the appointment of a common representative to hold the security interests for the various holders of the notes from time to time, who can exercise its rights without the need for a special proxy or mandate. This is a significant benefit because Italian law usually does not recognise the use of a trust or the appointment of a security trustee, and requires the secured lenders to also appear as registered holders of any security.

- In the face of the COVID-19 pandemic, debt notes which had a credit rating of at least BBB-were effectively granted public aid, similar to that afforded to bank loans, through a guarantee from SACE S.p.A..

[6] In the meaning of article 2412, paragraph 2, of the Italian civil code

[7] Article 46, paragraph 1-*bis* of legislative decree No. 385 of 1 September 1993

[8] Article 2414-*bis*

Fronting bank structures are no longer available

In a further significant development, Italy's criminal Court of Cassation[9] ruled against the use of fronting bank structures by foreign lenders that are not licensed in Italy (the "**IBLOR Judgment**").

This financing technique involved investors arranging for an Italian licensed lender of record to provide the debt to the Italian borrower and to retain the main contractual relationship with the borrower, whilst the investors took on the economic risk of the lending transaction behind the scenes via funded or unfunded sub-participation or risk-sharing schemes.

Fronting structures had been popular in Italy for decades, not just to overcome regulatory restrictions, but also to limit the lenders' exposure to Italian withholding tax on interest. However, this popularity substantially decreased after the enactment in 2014 of a special exemption from Italian withholding tax for certain eligible foreign lenders (such as EU banks, EU insurance companies and certain undertakings for collective investment established in countries ensuring an adequate exchange of information with Italy, provided they are fully licenced to lend in Italy) disbursing loans with a maturity exceeding 18 months to Italian businesses.

The IBLOR Case did address a relatively unusual structure, but the principles followed and legal arguments used are very broad, and point to wide-ranging effects. Indeed, the Court's decision emphasised factors which are actually found in most, if not all, participation or sub-participation schemes, such as:

- the participant sharing in the borrower's insolvency risk;
- the participant's independent assessment of the borrower's credit standing;

[9] Fifth Criminal Section of Italy's Supreme Court of Cassation, judgment No. 12777/2019, published on 22 March 2019.

- the borrower's acknowledgement of the participant's involvement and role;
- the participant's ability to interfere in the day-by-day credit relationship; and
- the size of the participant's exposure being in excess of that of the fronting bank.

We have reported on the IBLOR Case in more detail **here**[10]. This development has influenced the practice in Italy significantly, and the use of fronting structures was discontinued in favour of the alternative structures which we describe below, as well as hybrid loans-debt notes arrangements.

The rise of the alternative lending structures

Domestic and EU banks have retained a predominant role in the Italian loans market, favoured by tax regulation and the Eurosystem's monetary policy in the last decade. The market share and relevance of private lenders have increased consistently, however, since the first deals done by debt funds back in early 2010.

Investors not qualifying for clearance by the Bank of Italy to lend, have continued to rely on alternative lending structures, such as making loans to SPVs or holdcos established in Luxembourg or other jurisdictions with a lender-friendly enforcement environment, which in turn on-lend the proceeds to an Italian business. For second lien and other junior lenders, a popular lending structure is to participate as a sponsor affiliate via the taking of equity, so as to qualify for the intragroup lending exemption from bank licensing requirements[11].

Despite the increased complexity in the process and documentation, the issuance of debt paper is increasing its role in the Italian market, including in connection with structured and specialised credit transactions which place much emphasis on the security. This has also remained true for smaller transactions in mini-bond and commercial paper. The Technical University of

[10] Italy's Supreme Criminal Court holds IBLOR fronting structures illegal - **Link** to the article, case of April 2019

[11] Article 1, para. 1(e) of the decree of the Italian Ministry of Economy and Finance No. 53 of 2 April 2015

Milan has updated its review[12] of the Italian mini-bond market (limited to issues for EUR 50 million or less), showing a consistent increase despite the recent disruptive events, with 182 issues in 2019, 173 in 2020 and 200 in 2022.

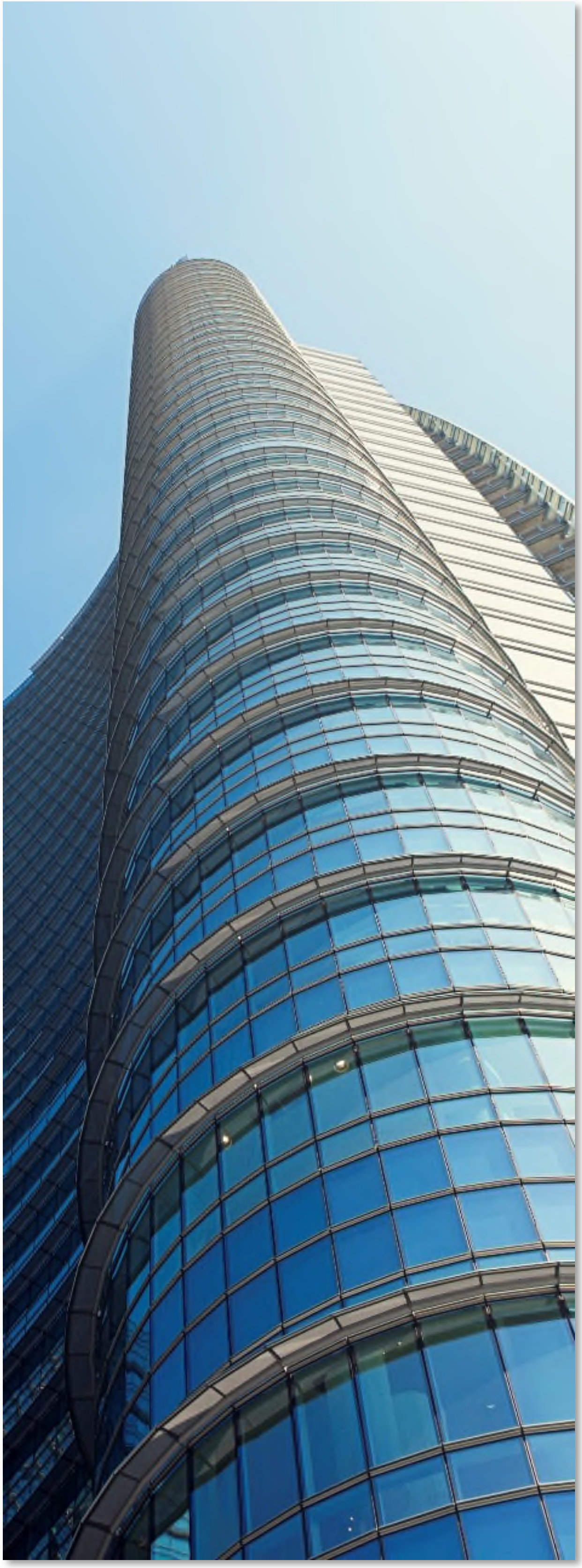
There is increased collaboration between debt funds and Italian banks to support borrowers in hybrid financing structures, where the banks provide revolving credit and the direct lenders participate via one of the alternatives discussed above.

Key advice for new entrants

European debt funds looking outside of the UK and the Nordics could find Italy to be a good destination. Whilst Italy is not the most straightforward of jurisdictions in which to lend, with careful structuring and tax advice, 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.

Hogan Lovells

March 2023



[12] Politecnico di Milano, Osservatorio Mini-Bond, 8th Report on Mini-Bonds, March 2022

Your key contacts

Carlo Massini
Banking
Partner, Milan
T +39 02 72025 2394
carlo.massini@hoganlovells.com

Serena Pietrosanti
Tax
Head of Tax - Italy, Rome
T +39 06 6758 2322
serena.pietrosanti@hoganlovells.com

Jeffrey Greenbaum
Regulatory
Partner, Rome
T +39 06 6758 2328
jeffrey.greenbaum@hoganlovells.com

Maria Cristina Conte
Tax
Senior Associate, Rome
T +39 06 6758 2322
mariacristina.conte@hoganlovells.com

Claudia Colomba
Regulatory
Senior Associate, Rome
T +39 06 6758 2322
claudia.colomba@hoganlovells.com

Penny Angell
Office Managing Partner - UK
T +44 20 7296 5786
penny.angell@hoganlovells.com

Paul Mullen
Partner, London
T +44 20 7296 5390
paul.mullen@hoganlovells.com

Jo Robinson
Partner, London
T +44 20 7296 5742
jo.robinson@hoganlovells.com

Matthew Cottis
Partner, London
T +44 20 7296 5482
matthew.cottis@hoganlovells.com

Francis Booth
Partner, London
T +44 20 7296 5646
francis.booth@hoganlovells.com

Susan Whitehead
Senior Consultant, London
T +44 20 7296 2635
susan.whitehead@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Boston
Brussels
Budapest*
Colorado Springs
Denver
Dubai
Dublin
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta*
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Munich
New York
Northern Virginia
Paris
Philadelphia
Riyadh*
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ*
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar*
Warsaw
Washington, D.C.

*Our associated offices

Legal Services Center: Berlin

www.hoganlovells.com