LEGAL COLUMN

Finally up and running

The Italian covered bonds regime has seen numerous setbacks over the past two years and until recently it faced a dubious future. In the first half of 2005, amendments to the Italian Securitisation Law 130/1999 tried to pave the way to a new and improved Italian covered bonds regime. But the legislative provisions lacked teeth, and a first draft of implementing regulations in 2006 was also roundly seen as too rigid. The market had been truncated at birth. But a new decree and new regulations have at last changed its fortunes. By **Nicole Purin** and **Dominic Griffiths** in Mayer Brown's London Finance Group, with assistance from **Gianluca Cambareri**, Tonucci & Partners, Rome.

Bankers following the Italian covered bond market finally had reason to smile when minister of the economy and finance, Tommaso Padoa-Schioppa, validated decree 310 of December 14 2006, and then when the Bank of Italy introduced more flexible regulations for the market in May 2007. The changes were designed to encourage the growth of a covered bond market on a par with other European markets.

The current law enables Italian banks to issue covered bonds with a guarantee from an SPV, secured by assets that have been sold by the bank to the SPV. The receivables purchased by the SPV represent a segregated portfolio and the SPV is insolvency remote.

The guarantee from the SPV must be irrevocable, unconditional and separate from the obligations of the bank issuing the covered bonds. It will also be enforceable on the issuing bank's failure to pay or on insolvency, within the limits of the assigned assets, on the basis of the bankruptcy remoteness of the SPV.

The receivables must fall into certain categories, as described below:

a) residential mortgage loans, provided that the ratio of the value of the mortgages issued by the originating bank and any other mortgage on the same property to the value of the property (LTV) is less than 80% of the value of the property (if the assets are in the EU or Switzerland and the terms of any applicable claw-back periods have expired in the relevant jurisdiction);

b) commercial mortgage loans, provided that the LTV is less than 60% (if the assets are in the EU or Switzerland and the terms of any applicable claw-back periods have expired in the relevant jurisdiction);

c) loans to all public administrations, including ministries, public territorial entities and any other public entity or body – both national and local – of any member state of the EU or Switzerland, provided that the risk weighting of exposures to that entity under the standardised approach to credit risk capital requirements under Basel II is not higher than 20%;

d) loans to public administrations of any non-member state, provided that they must have a zero risk weighting in the case of central governments or 20% risk weighting in the case of public territorial entities and other non-economic public entities – both national and local; and;

e) asset-backed securities that represent no less than 95% of the value of the segregated portfolio and have risk weightings no higher than 20%, whose repayment is not subordinated to the issue of other assets in the same transaction.

Under the original 2006 provisions, in order to issue covered bonds, the originator/issuer needed consolidated regulatory capital (CRC) of €500m, a CRC ratio of at least 10% and a consolidated Tier 1 capital ratio of at least 6%.

These parameters were much criticised by the Italian banking community as being too restrictive. The final version of the Bank of Italy Regulation of May 2007 imposes a lower minimum CRC ratio of 9% and accordingly it opens the market to the most significant national players.

The limits are as follows: (i) banks with a CRC ratio of at least 11% and a Tier 1 ratio of at least 7% face no limits to the amount of assets that can be transferred to the SPV; (ii) those with a CRC ratio between 10% and 11%, and a Tier 1 ratio of at least 6.5% can transfer 60% of their assets to the SPV; and (iii) banks with a CRC ratio between 9% and 10% and a Tier 1 ratio of at least 6% can transfer only 25% of assets to the SPV.

Most important, the new Italian legislation appears to be in line with the criteria envisaged by the rating agencies. Fitch has identified four key areas that need to be considered (and the relative weights to be given to each) when measuring the risk that payments owed to investors might be interrupted in the event of an insolvency of the issuer:

1) segregation of the cover assets backing the issues of covered bonds from the bankruptcy estate of the issuing financial institution (50% weight) – under the new Italian legislation, asset segregation is achieved by the transfer of the assets to a bankruptcy remote special purpose vehicle acting as a guarantor of the issued covered bonds;

2) alternative management of the cover assets and the covered bonds (15% weight) – the legislation provides that in the event of the issuer's mandatory winding up (liquidazione coatta amministrativa) the SPV shall represent the bondholders vis-a-vis the issuer;

3) liquidity gaps between the respective amortisation profiles of the cover pool and the covered bonds (30% weight) – the Bank of Italy's prescriptions provide that the net value of the segregated assets must be at least equal to the net value of the covered bonds and that interests and other revenues generated by the cover pool must match all the costs due on the covered bonds; also, the supervisory legislation introduces specific strategies of asset and liability management for banks to follow in order to bridge potential maturity mismatches;

4) dedicated covered bonds oversight (5% weight) – the Bank of Italy imposes specific transaction guidelines and will supervise banks' implementation as part of its overall mission to safeguard the stability of the domestic banking environment.

The new regime appears to be characterised by a high level of innovation, both legally and commercially. The regime has introduced liquidity safeguards and robust strategies of asset and liability management designed to maintain a balance between protecting the interests of creditors and the creation of a potentially large covered bond market.

In addition, the regime envisages the possibility of multi-seller issues in line with the Spanish Cedulas Hipotecarias. The foundations for growth have been laid and the future of the Italian covered bond market seems bright.