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News Flash

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Destination Italy Decree – New Legislative Measures to Encourage Debt Capital Markets Transactions

The Italian government has introduced a new decree, now converted into law, to encourage debt capital markets transactions by expanding favorable tax treatment.

As banks adapt to new capital requirements, bank finance — traditionally the source of the majority of credit extended to Italian businesses — has become less available for small and medium businesses. The debt capital markets have emerged as a growing alternative to bank finance, giving rise to a dramatic increase in the number of new issuances by Italian companies on the international markets. The liberalization of corporate bond issuances by Italian unlisted companies, including small and medium-sized enterprises (SMEs), under the so-called Decreto Sviluppo (Development Decree)[1] allowed institutional and qualified persons to invest directly in such debt instruments. One of the gaps in fostering the debt capital markets as an alternative to bank finance is encouraging domestic demand for bonds.

To further facilitate bond issuances by SMEs and encourage the development of an Italian debt capital market, the Italian government has adopted new measures to encourage demand for SME-issued corporate bonds and to streamline debt capital markets transactions generally:

- The extension of the withholding tax exemption to investment funds investing in bonds
- The extension of the *privilegio speciale* (special lien) to corporate bonds
- The extension of the tax relief regime of the substitute tax (*imposta sostitutiva*) to corporate bonds
- The possibility for banks to issue bonds guaranteed by financial assets
- The fostering of domestic Italian demand for corporate bonds by insurers and pension funds
- The extension and simplification of the rules governing securitization transactions involving corporate bonds

The "Destination Italy" Decree

On December 13, 2013, the Council of Ministers approved Law Decree No. 145 of December 23, 2013 (the Destination Italy Decree)[2] containing a package of measures to revive the Italian economy and introducing new rules aimed at attracting investors. Following the 2012 Development Decree reforms — which opened the market for debt capital markets transactions by private companies — the Destination Italy Decree, among other things, seeks to remove obstacles which market participants had highlighted as limiting Italian companies' access to the debt capital markets.

The Destination Italy Decree was converted into law without modification on February 19, 2014 following the approval by the Parliament. The conversion law will enter into force one day following its publication in the Official Gazette.

The following briefly describes the main measures introduced by the Destination Italy Decree.

Extension of the withholding tax exemption to investment funds investing in bonds

The first significant reform introduced by the Destination Italy Decree is the extension of the withholding tax exemption. Withholding tax generally applies to interest and other amounts paid in relation to bonds, certain other securities and promissory notes. Article 32 of the Development Decree established an exemption to the 20 percent withholding tax for payments made on bonds issued by non-publicly traded Italian companies provided that the securities are listed on a regulated market or multilateral trading facility or held by professional investors who are not shareholders of the issuer and not resident in certain tax havens (so-called blacklist countries). The Destination Italy Decree further extends the withholding tax exemption to collective investment funds so as long as their units are held by qualified investors and the assets under management are primarily invested in bonds, similar debt instruments or promissory notes.

This measure should encourage the development of an Italian private placement market, already a well-established method of debt capital raising in the US. There is no need for the private placement notes to be listed on a regulated market or multilateral trading system.

Extension of the *privilegio speciale* to corporate bonds

The Destination Italy Decree extends a type of security common in bank finance transactions to corporate bond issuances: the *privilegio speciale*, comparable to a floating charge, provided by Article 46 of Legislative Decree No. 385 of September 1, 1993 and originally intended only as additional security for bank loans. The *privilegio speciale* — often part of the security package for revolving credit facilities and term loans — was heretofore unavailable to bonds. As a result of the Destination Italy Decree, the *privilegio speciale* is now available to secure corporate bonds that are:

- Of medium-and long-term tenor[3]
- Issued by joint stock companies (*società per azioni*)
- Subscribed by qualified investors
- Approved for trading only among such investors

The *privilegio speciale* creates security over all of the assets of the issuer of the bond, including, for example, corporate assets such as machinery, equipment, raw materials, inventory and receivables, current and future. As a result, by taking security over multiple assets, the bond creditors avoid activating multiple notice and hardening periods which could expose them to claw back actions by the issuer's other creditors. It is expected that private placements of corporate bonds would be the asset class mostly likely to benefit from the extension of *privilegio speciale* because such investors tend to hold the bonds until maturity. In contrast, bonds that are freely tradable on an exchange (such as high yield bonds) can eventually become held by non-qualified investors, thereby defeating the extension of the *privilegio speciale*.

Extension of the tax relief regime of the substitute tax to corporate bonds

The Destination Italy Decree extends the applicability of the substitute tax regime to bond issuances and certain other securities, thereby harmonizing the tax treatment with that of bank finance loans. The substitute tax provides for 0.25 percent tax on the aggregate amount of bonds issued. The Destination Italy Decree abolishes the previous tax regime for bonds (which involved the application of registration tax, stamp duty, mortgage tax and/or duty register, with costs ranging from 168 Euro to 3 percent of the value of the asset).

The substitute tax regime is broadly applicable and extends to all types of security, whether provided at the time of initial bond issuance or subsequently, or in connection with exchanges and amendments to the bond. In addition, the extension of the substitute tax regime applies to subrogation, substitution, postponements, cancellations and partial splits of the security as well as transfers of security resulting from the sale of the bonds, including any modification or termination of the security.

The Destination Italy Decree also reformed the applicability of the substitute tax regime and made it optional with such treatment to be determined at bond issuance in the resolution of the governing body of the issuer.

The substitute tax is due and payable from the arranging or underwriting banks that promote and place the bonds[4] for which the issuer is jointly and severally liable. In instances where no underwriting banks are involved in the transaction, the substitute tax is due and payable directly by the issuer.

The possibility for banks to issue bonds guaranteed by financial assets

The Destination Italy Decree now allows the issuance of bonds — other than covered bonds — secured, among other things, by means of (i) debt securities issued by unlisted companies, (ii) securities issued by securitization vehicles having corporate bonds as underlying assets and (iii) loans to SMEs. The development of a collateralized debt obligation market may bring more liquidity into the domestic debt capital market.

Incentives for Italian insurers and pension funds

The Destination Italy Decree modifies both the regulatory framework establishing technical reserves for Italian insurers and the investment guidelines for pension funds — expanding such entities' ability to allocate a larger percentage of their portfolios to corporate bonds and related assets, including collateralized debt obligations backed by corporate bonds and funds with corporate bond investment strategies. The Destination Italy Decree's provisions will permit Italian insurers and pension funds to hold eligible debt capital markets products that are unrated and not listed on a regulated market or multilateral trading facility — provided the products are compatible with technical reserves for insurers and pension fund investment guidelines.

The Destination Italy Decree requires that the Italian Insurance Supervisory Authority (IVASS) promulgate modifications regarding technical reserves — within 30 days of the entry into force of the Destination Italy Decree — which comply with applicable laws regarding portfolio protection and stimulating domestic demand for debt capital markets products.

On January 23, 2014, IVASS issued a letter[5] indicating the planned modifications to the regulation regarding, among other things, technical reserves for Italian insurers6 for corporate bonds and bonds issued by securitization vehicles. Such modifications are planned for the first quarter of 2014.

With respect to corporate bonds, technical reserves for insurers will include a new asset category, “Bonds and similar instruments,” that can comprise up to 3 percent of technical reserves. As a modification from the existing requirements, bonds in this new asset category do not have to be admitted to a regulated market, can be issued by companies constituted within one year, can have tenors of more than one year and do not have to be issued by companies with three years of audited financial statements.

With respect to bonds issued by securitization vehicles, technical reserves for insurers will include a new asset category within securitization assets, “Securitization bonds,” that can comprise up to 3 percent of technical reserves. Eligible securitization bonds are exempt from the credit rating requirements otherwise applicable to securitized assets and may have as their underlying asset corporate bonds, including instruments eligible to be held as “Bonds and similar instruments.”

Securitization framework expanded and simplified

Destination Italy Decree extends, save for certain exceptions, the applicability of Law 130/99 (the Italian Securitization Law) to sales of corporate bonds by securitization vehicles. Furthermore, the Destination Italy Decree eliminates certain requirements and obligations related to securitization transactions, reducing transaction and advisory costs.

Among the modifications to the securitization framework introduced by the Destination Italy Decree, the following are the most significant:

- **Regulatory provisions eliminated**: In the case of securitization, the purchaser can be a single investor — as long as such investor is a qualified investor — in order to facilitate flexibility in the structuring of securitization transactions, provisions which would have the effect of changing the regulatory treatment of the transaction or parties involved have been eliminated.

- **Restructuring clarified**: The securitization pool is not available to creditors of the servicer, subservicer or depositary bank in an insolvency situation of any of these entities, thereby removing a grey area in the jurisprudence which would render such assets exposed to such creditors and was contrary to segregation and bankruptcy-remote principles of securitization.

- **Notification requirements reduced**: The Destination Italy Decree simplifies the procedures for securitization based on factoring of trade receivables by reducing the formalities required to notify debtors of the factoring transaction. In particular, the Destination Italy Decree permits securitization participants to apply the formalities in the Factoring Law[7], eliminating, for such credit class, the need to bundle the factoring transactions in order to comply with the notice requirements. This reform results in reduced transaction costs related to the publication in the Official Gazette of each factoring operation.

- **Recording formalities streamlined**: The Destination Italy Decree also streamlines formalities under the Factoring Law by allowing the use of a simple annotation of the factoring transaction in the records of the seller of the trade receivable in order for such transaction to be cognizable vis-à-vis third parties.

- **Trade receivables treatment harmonized**: The Destination Italy Decree also harmonizes the treatment of trade receivables related to public entities with those related to private entities. In particular, payments that expire on the day of bankruptcy or prior are no longer considered ineffective[8] as long as they were made by the bankrupt entity in the two years prior to the bankruptcy and insofar as they are related to securitization notes.

Conclusion

In conclusion, the Destination Italy Decree represents another initiative by the Italian government to further encourage the growth of the Italian debt capital markets and foster domestic demand. While the Development Decree successfully unlocked the high yield bond market for unlisted Italian companies with respect to the international markets, there remains the need to create an Italian debt capital market where institutional investors can invest in unrated bonds or securitization notes backed by corporate debt. In addition, the extension of the *privilegio speciale* to bondholders provides a new credit support alternatives for certain bond transactions and reduces uncertainty regarding Italian insolvency law risks that are present in the taking of security.

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[1] Law Decree No. 83 of June 22, 2012, as converted into law with modifications, Law No. 134 of August 7, 2012.

[2] The Decree was published in the Official Gazette no. 300 of December 23, 2013 and it is in force since December 24, 2013.

[3] Bonds with maturity of 18 months or less.

[4] The activities of such financial intermediaries are regulated by Legislative Decree No. 58 of February 24, 1998.

[5] IVASS, Prot. n. 51-14-000098 (January 23, 2014).

[6] IVASS Regulation 36/2011.

[7] Law No. 52/1991.

[8] Under Article 65 of Royal Decree No. 267 (March 16, 1942) (Italian Bankruptcy Law).