

**BANCA COMMERCIALE ITALIANA**

**Development of  
securitisation  
in Italy**

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# Development of securitisation in Italy

Francesco Caputo-Nassetti  
Banca Commerciale Italiana, Tokyo

## Introduction

Securitisation in Italy is still in its early stages of development, but the subject always provokes considerable interest and numerous articles have now been written about it. Some first steps (in the form of specific transactions) have recently been taken, resulting in both the formal introduction of securitisation in Italy and its simultaneous advancement.

This chapter analyses, with particular reference to the Italian market (which has many similarities to other, more established markets), four aspects of securitisation and its development:

- 1 the type of assets typically found in Italy with the correct requisites for securitisation;
- 2 the motives behind the drive towards securitisation in Italy;
- 3 the problems and obstacles which hinder the development of securitisation in Italy; and
- 4 case precedents, including a detailed case study analysis on the Lit140 billion Auriga Srl lease receivables securitisation.

## The assets

The main assets, with the requisites which render them suitable for a securitisation programme, are similar in nature, if not totally in form, to those which have already been securitised in the more established markets. The main categories could be summarised as follows:

- 1 residential mortgages;
- 2 car loans;
- 3 consumer credit;
- 4 lease rentals;
- 5 credit card receivables; and
- 6 trade receivables.

Because of various external pressures (discussed below), the two categories for which there is likely to be more demand are residential mortgages and car finance. The brief analysis given below therefore focuses on these markets, as well as offering some general comments on the leasing and credit card markets.

## Residential mortgages

The financial institutions which are active in the Italian mortgage market may be classified as follows: (a) mortgage institutions (90 per cent owned by banks) and special sections of banks; (b) commercial banks; (c) *finanziarie*, which are either typically owned by foreign banks (e.g. Citifin, Abbey National, etc.) or privately owned.

The specialised institutions which form part of: (a) above are currently 21 in number. Three are able to operate nationwide, six are regional public institutions and the remainder are special sections of public law banks or savings banks. The top three institutions together hold more than 50 per cent market share of the group as a whole, with only four others able to attain in excess of 5 per cent.

The volume of the mortgage market in Italy is difficult to ascertain, because only the lenders in groups (a) and (b) report to the Bank of Italy and only the aggregate data on mortgages provided by group (a) are published. According to the latest figures available from the Bank of Italy, at the end of 1989 the total volume of mortgage finance outstanding on the books of the institutions in group (a) was approximately Lit68,000 billion, an increase of 17 per cent over the previous year.

Useful information, from which certain deductions may be made, is available from other sources. The estimated turnover in the real estate market in Italy is currently in excess of Lit60,000 billion per annum, a relatively large percentage of which is financed through the mortgage market. A survey produced by Centro Studi AICI – Associazione Italiana Consulenti Immobiliari – showed turnover levels in 1988 of Lit62,000 billion and annual house sales of 500,000.

Based on a survey of the EC Mortgage Federation, at the end of 1989 the Italian mortgage market was the fifth largest in Europe (after Germany, the United Kingdom, France and Denmark), with total mortgage finance outstanding of Ecu64 billion (Lit96,000 billion).

The mortgage institutions, banks and their special sections are subject to the supervision of the Bank of Italy. The activities of the mortgage institutions and special sections in particular, were subject to a specific Act of Parliament passed in 1976 (DPR no. 7 of 21.1.76), which sets out guidelines and criteria which had to be adhered to for example, the tenor of the mortgage agreement granted cannot be less than 10 years and the loan-to-value (LTV) ratio cannot be in excess of 50 per cent.

The Italian parliament recently passed a new bill (Law no. 175 dated 6 June 1991) which creates more competition in the field of mortgage lending by allowing mortgage institutions to operate in the short term, to enter the field of industrial/commercial mortgage lending and to exceed the conservative 50 per cent LTV ratio. It also allows entrance to the market to all the regional *mediocrediti* who were previously barred from the activity.

Historically the standard LTV ratio applied by the commercial banks and *finanziarie* has also been 50 per cent. However, recent market trends, based on customer demand, have resulted in this percentage edging upwards as far as 70–75 per cent. Notwithstanding this increase and the steady growth in volume experienced in the mortgage market, the arrears/losses ratios continue to remain relatively low. The extremely conservative LTV ratio still, on average, being applied has meant that the losses ratio, in particular, remains below the international average.

Mortgages are usually granted for a term which ranges between five and 25 years, but in practice very few mortgages are granted in excess of 15 years and the maturity most frequently requested and granted is 10 years. A small but insignificant portion of mortgages is granted for specific purposes with a state subsidy. The market is obviously mainly Italian lire denominated, but an increasing percentage of new mortgages (because of lower interest rates and an acceptable exchange rate risk) is denominated in Ecu. Mortgage loans may be subject to a fixed or floating

interest rate. In recent years, particularly because of the type of funding available, the trend has been towards offering more variable-rate mortgages. The most common, although not the sole, benchmarks for floating-rate Italian lire mortgages are the Italian prime-rate, being the main parameter used by the commercial banks, and 'Rolint' (an average of the domestic interbank rate and the medium-term Treasury yield), being the main parameter of the mortgage institutions.

The main type of mortgage granted is the traditional repayment mortgage, but endowment mortgages have recently been introduced and are steadily gaining in popularity.

Due to the breakage costs involved, the average prepayment rate is extremely low (3.5 per cent). A mortgage loan is subject to payment of a mortgage tax (*imposta sostitutiva*). In the event of sale of property on which a mortgage has already been granted, the mortgage loan is simply transferred (*accollo di debito*) to the purchaser together with the property. The agreed price is reduced by the amount of the outstanding mortgage loan. Apart from the mortgage tax, a prepayment penalty fee would be commonly charged in the event of foreclosure of the loan.

The source of funding for mortgage lending is derived principally from domestic bond issues, certificates of deposit and syndicated Euroloans. The average margin earned above cost is approximately 3 per cent; commercial banks with a customer deposit base benefit from a wider spread between their cost of funding and the mortgage rate. For this reason, they are able to be more aggressive in pricing than their competitors. They generally, however, apply stricter lending criteria. Conversely, the *finanziarie* have more relaxed lending criteria but apply higher margins. Consequently, a house purchaser is able, on the basis of his financial standing or preferences, to opt between a higher rate mortgage granted with few formalities and obligations and a lower rate mortgage which may require detailed information or greater security.

### **The auto loan market**

More than two million new vehicles are sold in Italy every year (2,362,000 in 1989) for an aggregate value of more than Lit60,000 billion (US\$55 billion). According to Moody's, which has recently made a detailed survey of the Italian auto loan market (the results of which are reported here with Moody's consent), roughly 60 per cent of new car buyers and 20 per cent of used car buyers finance their auto purchase.

Banks hold an approximate 50 per cent share of the Italian auto loan market, a percentage which has been accumulated only relatively recently (over five-seven years) and which is continuing to increase. Monte dei Paschi, Banca Commerciale Italiana and Banca Nazionale del Lavoro are among the most active participants in the field. Currently, banks rely on their own marketing skills, because banking laws in Italy prevent them from paying dealer commissions to third party originators.

The automotive captive finance companies, which account for 28 per cent of the market, include Fiatsava, Fiat's captive finance company; PSA Fin, wholly owned by Peugeot; FinRenault; Ford Credit; Merfina, owned by Mercedes, and GMAC. These companies, unlike banks, solicit business through auto dealerships.

The finance subsidiaries of both foreign and domestic banks operating in Italy hold a 16 per cent market share. Some of the major players are Citifin; Compass, owned by Mediobanca; Chasefin, Chase Manhattan's finance subsidiary in Italy; and Findomestic, owned by Compagnie Financière of France and a consortium of Italian banks. These solicit business through agents or dealers and operate in a similar fashion to automotive captive finance companies.

The average original term to maturity for Italian auto loans is about three years. Loans are typically repayable monthly and have high prepayment penalty fees, a factor which significantly reduces prepayment rates. Interest rates on auto loans applied by captive finance companies and

bank finance subsidiaries are generally much higher than those applied by banks. This again is a reflection of the banks' lower funding costs and the restrictive regulations banks have to comply with. As a result, auto buyers choose between: (a) higher rate loans from finance companies or bank subsidiaries obtained with relative ease through the dealer; and (b) lower rate bank loans that may carry more onerous terms and conditions.

Many auto lenders do not take liens on autos in Italy. Obtaining a lien is a very time consuming and costly process and the lender weighs those costs against the probability of default and the expected recovery values of repossessed vehicles. Vehicles repossessed through enforcement of liens must be sold in accordance with a court order by auction, where buyers tend to pay relatively low prices, a procedure which reduces any benefits the lien itself may presuppose. Furthermore, there tend to be fewer defaults in the northern part of Italy, where the unemployment rate has remained relatively low, a factor which diminishes still further the advantage of having obtained a lien; liens are, in fact, more frequently obtained in southern Italy.

### **The leasing market**

Having been established in the early 1960s, the Italian leasing sector has developed into a relatively mature market.

The companies which grant leases are of three main types: (a) the bank leasing companies, subsidiaries, or part, of a banking group; (b) the captive leasing companies which form part of domestic or foreign industrial or commercial groups, such as IBM, Fiat, Mercedes, etc.; and (c) general privately owned leasing companies.

While the bank leasing companies have an unlimited supply of funding, for obvious reasons, the remainder have to rely on external lines of credit or parent support to finance their business; this adversely affects their plans for expansion.

Until recently other than Assilea, a national association for leasing companies with about 60 of the largest leasing companies as members, the leasing sector was not governed by any supervisory body; nor have any laws been passed to regulate its activity, although the bank leasing companies are subject to indirect, and limited, control by the Bank of Italy. A new bill (Law no. 197 dated 5 July 1990) sets the first form of supervision in the leasing sector as a whole: minimum capital requirements are established, a national register and a reporting system are set up etc.

In comparison to the mortgage market, there are also no formalities which in any way block entrance to newcomers to the leasing sector. At the moment, in excess of 1,000 leasing companies operate in Italy and the market has grown considerably: in 1989, 216,111 contracts were concluded for a nominal amount of Lit11,465 billion (approximately US\$10 billion), an increase over 1988 of 11.3 per cent in the number of contracts and 8.2 per cent in the respective nominal amount.

There are now more than 240 companies operating in the field of car leasing alone, although 49.7 per cent of the market is in the hands of the top eight leasing groups. In 1989 205,000 vehicles with a value of Lit5,200 billion (US\$4.5 billion) were leased out, resulting in an annual market growth rate of 13 per cent. In the same year 8.76 per cent of all cars sold were subsequently leased.

Because there are so many companies, competition is extremely fierce. Over recent years, however, the trend is one of decreasing numbers as smaller companies give up the struggle. The sector has to compete with the alternatives on offer in the field of car finance: auto loans and car rentals.

The lease rentals can either be by reference to a fixed-rate or to a floating-rate (in either case, the most common benchmarks are the Italian prime-rate and the domestic interbank rate). An

increasingly common trend, however, is to have indexation to Ecu interest and exchange rates. The margin above cost can vary from 8 per cent to 10 per cent and average terms range from two to five years.

### **The credit card market**

The use of credit cards in Italy is as yet not widespread – a recent survey showed that only 9 per cent of Italian families own a credit card – but it is growing rapidly. There are approximately 4.4 million cardholders and the total currently outstanding is approximately Lit11,000 billion (US\$9.6 billion).

The main cards are Cartasi (issued by Servizi Interbancari SpA, which is owned by a consortium of commercial banks), Diners, American Express, Bankamericard (issued by Banca d'America e d'Italia, a wholly owned subsidiary of Deutsche Bank) and Topcard (issued by Banca Nazionale del Lavoro). The cards are accepted in approximately 560,000 outlets.

To date the sector remains unregulated.

### **The motives**

In the US, the UK, France and Australia, asset securitisation has been driven, on the originator side, by pressures on financial institutions to limit the size of their balance sheets, in accordance with regulatory capital restrictions and by the need of corporations to find alternative sources of funding. On the investor side, it reflects the flight to low risk, liquid securities. The evolving market in Italy appears to have been influenced by similar forces but also by regulations and restrictions peculiar to the Italian market.

As far as the Italian banking sector is concerned, one of the more compelling reasons to securitise its activities is the need to adhere to capital ratios established by the Bank of Italy. The majority of the Italian banking sector is state owned and therefore unable, without a relative increase in public sector expenditure, to re-capitalise itself. One of the major advantages of securitisation, as seen from the Italian perspective, is that it frees existing capital resources to finance new business: in other words, the same benefits achieved by an increase in capital are obtained. Furthermore, any general loan-loss provisions will increase in percentage terms *vis-à-vis* the remaining loan portfolio or, alternatively, may be capitalised as shareholders' funds.

Commercial banks face specific problems. They are traditionally short-term institutions and are therefore subjected to upward limits on their medium-term lending. The limits are a function of their capital base and, more importantly, the sum of their total lending activity. Broadly speaking, the volume of medium-term lending in Italian lire cannot exceed 30 per cent of total lire lending. A traditional part of all commercial banks' activities is the granting of mortgage finance, consumer credit and other forms of medium-term lending to their customers. A commercial bank therefore finds itself in a 'Catch-22' situation: in order to meet its customers' demands for medium-term funds, it has to increase its overall balance sheet; but it cannot increase its overall balance sheet because it is subject to capital adequacy ratios and is unable, in the majority of cases, to request an increase in capital from its shareholders. The only viable alternative is securitisation.

A further problem to which the Italian financial institutions may see securitisation as an answer is the need to find new sources of medium-term funding. The Italian state is a formidable competitor for domestic funds, so that domestic bond issues and certificates of deposits are extremely expensive for the issuer and the depth of the market is insufficient to satisfy the

growing demand. As if the situation was not bad enough, the flood of Italian financial institutions tapping the Euroloan market has caused an indiscriminate rise in pricing, especially with the usually excellent credit risks involved – and this trend does not appear to be slowing down. The hope is, therefore, that securitisation will make it possible to tap new categories of investors and new markets.

The same considerations are valid for the leasing sector, in particular for those companies which are not part of a banking group. Such companies' dependence (including that of even the larger leasing companies) on external funding sources, which are necessarily limited, result in a restriction in their relative business growth.

The leasing companies are subject to a further restriction related specifically to subsidised finance. In order to receive state subsidies, the leasing company applicant must have a relatively high proportion of its activity in leasing. As many leasing companies also engage in granting loans (especially auto loans) as an alternative to leases, an increase in such side activities could jeopardise their eligibility.

The natural investor base for Italian lire securities is obviously in Italy, but any issue of securities has to compete not only with the enormity of the Italian Treasury market (Italy has one of the largest public sector deficits in the world) but also with the preferential fiscal treatment afforded to Treasury bonds. Investment by an Italian resident in a Eurobond will generally be subject to a rate of taxation of 30 per cent on income receivable (see 'Fiscal aspects', below), while investment in Treasuries currently results in deduction at a rate of only 12.5 per cent.

It is obvious that any security which is neither state-issued nor exempt from withholding tax (such as paper issued by supranationals) is not particularly easy to place. Notwithstanding this, it may still be possible to develop a domestic investor base – at least theoretically – for a certain type of security known as *titoli atipici* (atypical bonds), because of the fiscal treatment afforded to them. Although no precedents as yet exist in Italy, the particular nature of a 'pass-through' security would probably put it in this category. As an exception to the general rule, the withholding tax deduction (currently 30 per cent) is classified as definitive not only for private individuals but also for corporations and it would therefore be exempt from inclusion in the latter's overall taxable income even if their applicable tax rate were to be in excess of 30 per cent (Law No. 649 of 23 November 1983). It is clear that institutional investors with a corporate tax rate in excess of 30 per cent may have an interest in investing in such securities as a valid alternative to Treasuries.

A further consequence of being able to securitise transactions via the issue of securities with a favourable fiscal treatment is the important knock-on effect this would have on the development of the mortgage market and thus other real estate market. Funds will be attracted to the finance of home ownership, which is also in line with the directives of Article 47, paragraph (iii), of the Italian Constitution, which specifically states that the Republic should encourage investment of private savings in home ownership.

As far as the banks are concerned, the risk asset weighting attributable to investments in securitised assets, which has yet to be determined by the Bank of Italy, will be an important factor in deciding whether or not to participate in such transactions.

The answer may lie in utilising an offshore vehicle, as used in most securitisation structures elsewhere and issuing a Eurobond, thereby tapping a more reliable source of investor.

In conclusion, all the prerequisites required for the development of a securitisation market are present in Italy. The pace of such development will depend principally on the speed with which the various legal and fiscal problems can be overcome.

## The problems

The main problems which have to be resolved in structuring a securitisation transaction for an Italian borrower are generally of three types: legal, fiscal and accountancy.

On the one hand, while the current total lack of regulations (exchange control regulations have also been abolished recently) allows a not insignificant flexibility in the structuring of a deal, there remains a worry that new laws or directives will be too stringent (or, worse still, unsatisfactory) and may be applied retroactively.

### Legal aspects

One of the most important processes of any securitisation structure is the method by which the risk of the underlying assets is transferred. Depending on the nature of the asset, this may generally be arrived at by means of: (a) novation; (b) assignment; and (c) sub-participation.

**Novation** As a general point, 'novation' under English law does not bear the same meaning as it does under Italian law. Whereas English law states that novation has the effect of creating completely new rights and obligations between the parties while previous rights and obligations are extinguished (for this reason, the novation documentation has to be signed by all parties to the original contract and all parties to the new contract), Italian law utilises the term in the stricter sense in which, subject to the agreement (*animus novandi*) of the parties concerned, novation would result in an existing obligation (*obligatio novanda*) being substituted (and considered extinguished) by a new but equivalent obligation between the same parties, involving either settlement by means of a different object or a change of the legal title of the obligation (*aliquid novi*). For example, X, who owes Y £1,000 in respect of damages, reaches an agreement with Y whereby either such amount will be considered to be, and has to be repayable as, a loan (change of legal title) or the obligation will be to deliver at some future date 100kg of grain instead of payment of the £1,000 (change of object).

The main difference, therefore, between novation as understood in the two jurisdictions – and it is particularly relevant to the matter of securitisation – is that an English novation ordinarily involves new parties, whereas an Italian novation is only between existing parties and therefore cannot be considered to be a method of transfer of an obligation. From this point in this text novation should be regarded in its English meaning.

Novation is not a very practical method (in the context of securitisation) of transferring assets, mainly for the following reasons:

- 1 it would require the explicit agreement of all the debtors whose obligations are being transferred, an unlikely scenario considering the high number of individual debts which ordinarily form part of a portfolio;
- 2 a mortgage tax (*imposta sostitutiva*) as referred to in Article 17 of DPR 601, 29.9.73) would be applicable to all assets transferred to an Italian resident (e.g. a domestic SPV) with a remaining maturity in excess of 18 months;
- 3 any security or guarantees which would also be subject to the transfer would have to be negotiated afresh, an extremely complex process which would effectively render the transaction uneconomical;
- 4 the investor would be exposed to the risk of insolvency of the grantor of the security in the event that it is declared bankrupt within a defined period of time after the act of novation. The length of such a period, which ordinarily ranges from one to two years, will depend on the



individual circumstances and will be determined pursuant to Article 67 of the Italian Bankruptcy Act (*legge fallimentare*); and

- 5 a disadvantage for the originator of the asset is that novation exposes him, again for a defined period of time as set out in the Bankruptcy Act and notwithstanding the sale, to the continued insolvency risk of the transferred debtor. As previously described, novation effectively extinguishes the previous debt even in the absence of funds movement. The liquidator may maintain that the creditor, who actually benefited from the novation, obtained preference *vis-à-vis* the remaining creditors of the debtor in question. It would be in the powers of the liquidator to have such preference considered void and to request the originator to pay an amount equal to the amount of the debt in question back to the liquidator.

**Assignment** The majority of the drawbacks mentioned above may be avoided under Italian law by effecting the transfer in the form of an assignment of contract (*cessione di contratto*). This type of assignment actually transfers both rights and obligations and not only the rights (as the English term ordinarily would imply); it may be considered roughly similar to an English novation without the original debt being extinguished. It can only be utilised whenever, under an existing contract, both parties have individual outstanding obligations. Assignment of contract cannot be used in the case of residential mortgages or auto loans, since the lender, once the loan has been drawn down, does not have any other outstanding contractual obligations, only rights. It may be used to securitise car leases, although this would have certain fiscal implications. The existence of reciprocal obligations means that, in order to render an assignment of contract effective, it must be explicitly accepted by each counterparty.

Another form of assignment more widely used is the assignment of credit (*cessione di credito*), which is in practice an assignment of the right to receive sums owed pursuant to a debt. This differs from the assignment of contract to the extent that it may be used in all cases whenever it is not necessary to transfer any related obligations. It is not, however, without its own drawbacks:

- 1 an assignment of credit must be notified to the debtor in order to render it effective and legally binding. This may have certain commercial disadvantages for the originator, who usually has relationship considerations to bear in mind and whose obvious preference would be to keep any assignment undisclosed. Furthermore, the traditional methods of notification are both costly and administratively complex; and
- 2 if the debt is covered by any security or guarantees it would be necessary to register the assignment at the land registry of vehicle registration office. This may entail additional problems because of the way certain fiscal authorities interpret Article 17 of the DPR 601, which states that, once the mortgage tax has been paid, no other form of taxation should be levied on a mortgage loan. Despite this, some authorities still insist on imposing a registration tax on the transfer of the mortgage.

An undisclosed assignment may also be used. However, as the original debtor has not been notified, the assignment is an agreement only between the assignor (originator) and assignee (investor) and not enforceable against, nor binding on, third parties (including a liquidator). In this event, the investor bears the insolvency risk of the originator as, if the originator becomes bankrupt after the assignment and during the term in which the securitisation transaction is outstanding, the liquidator will not recognise the assignment and will appropriate the cash flow of the assigned portfolio. Another separate disadvantage inherent in this method is that the debtor is legally entitled to offset its debt (which has been assigned) with any claim it may have against the originator.

Transfer without the need for registration would be possible, in the sole case of mortgage loans, if the loan itself is evidenced by a specific type of promissory note (*cambiale ipotecaria*) to be signed by the debtor. Although still a grey area, this instrument should render both the loan and the relevant mortgage transferable by endorsement without the need of registration, payment of taxes or any other formality. However, such instruments are not used in the market, because they are subject to stamp duty (currently 0.10 per cent flat) and they present practical problems in evidencing the full terms of the mortgage loan.

**Sub-participation** A sub-participation is based on the legal concept of a deposit, the repayment of which is conditional upon some future event occurring. In other words, following the purchase of a sub-participation, the sub-participant deposits a certain amount with the seller and agrees with the seller that such deposit will be repayable only on receipt by the latter of the relative repayment due under the underlying loan.

Although this method of risk transfer has in fact already been used in Italy, for the Chariots transaction (see under 'The case precedents', below) it cannot be considered the most efficient, and its use should depend principally on, and be considered in the light of, the final objectives of the originator in particular before a securitisation programme is instigated on this basis.

The most important consequence of implementing a securitisation programme based on sub-participation is that the originator remains lender of record and, particularly due to the fact that the sub-participant does not gain any legal rights directly against, nor has any direct legal relationship with, the debtor, it cannot be sustained that a 'true sale' has in effect been achieved.

As far as the legal implications are concerned, a major drawback is that the risk of insolvency of the originator is not eliminated. This means that not only does an investor run the risk of not being entitled to receive, in preference to the other general creditors of the originator, the cash flow of the securitised portfolio, notwithstanding this having been regularly paid by the debtors, but, because a debtor maintains a legal right of set-off against the originator (i.e. the debtor may legally compensate its debt against a right it may have against its creditor, the originator), it may also find itself having to sustain the credit risk of the originator itself for the full amount of the portfolio debt which has been offset.

Full direct rights on the portfolio are not therefore obtained by the investors. This aspect is of paramount importance in being able to convince investors to purchase the transaction and is one of the prime considerations of the rating companies in attributing the rating. Residual risk on the originator should be totally eliminated, as in the case of novation or disclosed assignment, or else it may be necessary, depending on the standing of the originator itself, to obtain a specific performance guarantee, the total risk exposure of which being effectively the total outstanding residual amount of the portfolio at any one time during the life of the securitisation transaction.

### **Fiscal aspects**

The two main fiscal elements which effectively dictate and determine for any given asset the structure of a securitisation transaction are withholding tax and taxation on security. In effect withholding tax is at present the major fiscal obstacle to securitisation in Italy. Under the current fiscal legislation, a resident would be obliged to deduct (subject to any concessions granted by the double taxation treaties between Italy and third countries) 15 per cent withholding tax from loan interest paid to a non-resident. In other words, deduction of withholding tax from interest payments would be necessary in the case of any interest bearing debt (such as a mortgage or car loan) which has been effectively sold to a non-resident (for example to an SPV resident in the Cayman Islands) by means of assignment or novation. Withholding tax is not applicable to

payments of any asset not having any interest element, such as general receivables.

The two principal deal structures which do not incur withholding tax are not without their disadvantages. The first is the form of method of transfer (i.e. by sub-participation, whereby principally domestic off-balance sheet treatment has to be sacrificed); the second is in the place of incorporation of the SPV (i.e. a domestic SPV would avoid withholding tax but there might be difficulties in obtaining court approval for the limited statutory object which the company must register in order to have the correct requisites of a special-purpose company).

Apart from the fiscal treatment of the portfolio payments, the other prime source for concern and investigation is the fiscal treatment of the SPV itself and the instruments by which it obtains funding. The current situation is summarised in Exhibit 32.1: all data should be read in conjunction with the notes that follow.

### Exhibit 32.1 Tax treatment from an issuer/investor perspective

<i>Issuer</i>	<i>Investor</i>	<i>Type of investment</i>	<i>Withholding tax rate (%)</i>	<i>Notes</i>
Offshore SPV	Non-resident	Eurobond	0	1
Offshore SPV	Resident	Eurobond	30	1
Domestic SPV	Non-resident	Domestic bond	30	2
	Resident			
Domestic SPV	Non-resident	Atypical securities	30	2
	Resident			
Republic of Italy	Non-resident	Treasuries	12.5	3
	Resident			
Supranational bodies	Non-resident	Eurobonds	0	3
	Resident			

In general, however, because domestic asset-backed securities have yet to be issued, the Italian fiscal authorities have not yet had to make any judgment as to their classification and treatment. The final securitisation structure and its fiscal implications will be of paramount importance to the survival and development of the product.

As a side note, the regulatory aspects of issuing a domestic asset-backed security should not be overlooked. As for all issues, the Bank of Italy and CONSOB, the regulatory body of the Italian stock exchange, will require full details of the transaction, and a fully comprehensive information memorandum/offering circular would have to be presented to CONSOB for its approval. The main problems, no doubt, will be those concerning the lack of precedents.

Briefly, other considerations on the fiscal front relate to: (a) problems which the individual debtor may incur as a result of the securitisation (i.e. the current fiscal legislation only allows a mortgagor tax relief on payments of interest on a residential mortgage loan which are payable to a mortgage institution resident in Italy); (b) VAT charges (all fees and commissions, such as servicing fees payable to an Italian resident, are subject to a VAT charge of 19 per cent, which would have to be quantified as a non-insignificant additional cost to the transaction if not recoverable); and (c) the profit extraction method.

The profit extraction method is an aspect of paramount importance – especially if the originator does not have any interest in the SPV – and with negative implications to the transaction and to the overall costs involved. This may be achieved in at least four diverse ways:

- 1 the originator grants to the SPV a subordinated loan, the payment of interest on which is relatively equal to the amount of profit to be extracted from time to time. The principal risk is that the relevant fiscal authorities of the SPV may consider such interest in excess of market rates and classify it as not deductible for tax purposes;
- 2 the sale of the portfolio may be subjected not only to the payment of par value but to a deferred consideration equal, again from time to time, to the excess profit earned by the SPV on the portfolio. As this effectively means that the sale of the portfolio has been agreed at a price in excess of par, this may not be regarded as a true market price for the assets;
- 3 the profit element may be taken into consideration when formulating the interest rate swap with the SPV. This may, however, cause structural and hedging problems; and
- 4 the excess profit may be paid to the servicer in the form of additional fees, although, as mentioned above, all fees earned by Italian residents are subject to VAT.

### **Accountancy aspects**

Accountancy treatment is usually of particular importance to the originator, who would ideally prefer to see, subsequent to the securitisation process, a reduction in the size of its balance sheet, improved financial ratios and total elimination of the credit risk inherent in the securitised portfolio.

In general, if the SPV is a subsidiary of the originator, the transferred assets would have to be included in the originator's consolidated balance sheet. The disadvantages are obvious; the advantages are, principally, in being able to receive dividends in respect of the surpluses which arise. In order to receive off-balance sheet treatment, the originator should not have any interest whatsoever in the SPV.

The other methods of transfer are accounted for differently. Sub-participations do not achieve off-balance treatment for the originator (the assets would remain evidenced as previous to securitisation and the sub-participations granted would have to be evidenced on the liability side of the balance sheet). Assignments, on the other hand, whether disclosed or not may be eliminated from the balance sheet.

## **The case precedents**

### **First attempts**

To date, only three public securitisation programmes have been launched in Italy, each different in nature but each signalling a definite step in the development of the product in a new environment. A brief outline of the first two follows. The third, which, due to its legal structure, is similar to the traditional securitisation structures used in the more developed markets such as those in the US and the UK, with all the benefits they entail, is the subject of a detailed case study.

The first attempt at securitisation in Italy was Chariots No. 1 Limited, signed in February 1990. The assets securitised were a portfolio of car loans originated by Citicorp Finanziaria SpA (Citifin). The legal structure used was a form of limited recourse financing with the underlying assets remaining on the originator's books and therefore its balance sheet. In practice Banca Commerciale Italiana (BCI) purchased a sub-participation in the car loans granted by Citifin which were designated as part of the programme. BCI obtained funding by, in turn, granting a sub-participation to the SPV, 'Chariots', the reimbursement of which was subject to Banca Commerciale Italiana (BCI) obtaining from Citifin debtors a corresponding amount, hence the

'limited recourse' nature. Chariots funded itself by means of a syndicated loan. The performance obligations of Citifin were backed by a performance guarantee of Citibank NA. On launch, the transaction was rated A1 but, in line with the downgrading of Citibank, was subsequently downgraded to A2.

The feasibility of this structure depends principally on the nature of the parties involved. Certain points, however, should be kept under consideration:

- 1 the requirement on Citibank NA to issue a performance guarantee which technically could be equal to the amount securitised (and the consequent costs in terms of capital this contingent liability may incur);
- 2 notwithstanding that no improvement was obtained in terms of the balance sheet ratios of Citifin (ie the assets, if not the risk, remained on Citifin's balance sheet), Citibank as a group benefited from the Chariots transaction, because of the generally accepted accounting principles in the US for the consolidation of balance sheets; and
- 3 no form of security was created, because the securitisation was funded by means of a syndicated loan.

The subsequent transaction was arranged by Swiss Bank Corporation for a portfolio of receivables originated by Parmalat, a medium sized dairy company located in northern Italy. The transaction was unrated and, although not many details of the structure were disclosed, the receivables appear to have been sold at substantially below par to an offshore SPV which subsequently funded itself on the Euromarket.

The third and most recent transaction was brought to the market by BCI; its main aim was to overcome the drawbacks of the previous transactions. The new transaction, more fully described in the case study which follows, took the form of a disclosed assignment of receivables to an SPV, 'Auriga', which in turn funded its purchase via the issue by BCI of Transfer Certificates. Auriga was not consolidated with the originator. The transaction successfully closed in March 1991 and was attributed an AAA rating by Moody's. Auriga represented one of the first securitisations in Europe of car lease receivables.

The main objectives of BCI in formulating the legal structure were:

- 1 the creation of a type of security which entitled the registered holder to receive the cash flow relating to the repayment of the principal and interest due on the investment; and
- 2 the complete removal of the assets from the balance sheet of the originator.

These objectives were both achieved.

## **The Auriga transaction**

### **The purchase of the receivables portfolio**

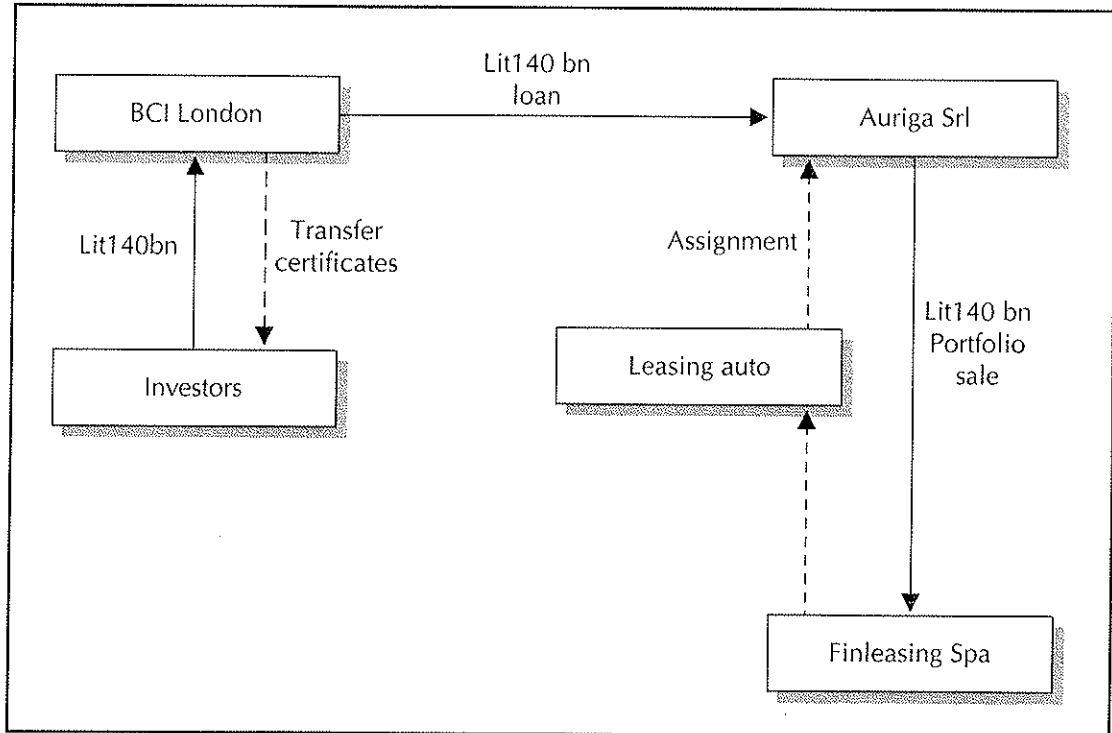
On the closing date the investors purchased Transfer Certificates (TCs) evidencing deposits with BCI, London for up to Lit140,000,000,000, pursuant to a deposit agreement (the deposit agreement). BCI utilised such deposits to fund a loan for up to Lit140,000,000,000 (the loan) to Auriga Sri (the borrower) pursuant to a loan agreement (the loan agreement) and the borrower utilised the proceeds of the loan to effect the payment due as consideration for the purchase of a portfolio of car lease receivables (the receivables portfolio) originated by Finleasing Italia SpA (the originator) (see Exhibit 32.2).

As used in this section, 'car leases' shall mean the leases which form part of the receivables portfolio and 'car lessees' shall mean the lessees of the car leases.

The purchase was perfected by way of assignment to Auriga. The car lessees were notified in accordance with Italian law that Finleasing had sold the credits but would continue to act as servicer.

The recourse of the investors to BCI London under the deposit agreement is limited to the amount received by BCI London pursuant to the loan agreement. The TCs are freely transferable without the prior consent of the borrower. The originator was appointed servicer of the receivables portfolio by Auriga, pursuant to a servicing agreement. Moody's Investors Services assigned a rating of AAA to the transaction.

**Exhibit 32.2 Capital cash flows in the Auriga securitisation**



### **Servicing and liquidity arrangements**

Under the servicing agreement, the originator was appointed to administer the receivables portfolio and, in its capacity as servicer, and subject to any restrictions contained in the servicing agreement, to exercise certain powers, rights and discretions vested in the borrower (as assignee under the assignment agreement) under or pursuant to the terms of the documentation evidencing the receivables portfolio, including:

- 1 periodically setting and resetting the interest rate or rates applicable to the car leases;
- 2 communicating and dealing with each car lessee and any other party in relation to any breach or default in respect of any car lease;
- 3 taking any action, in accordance with its usual arrears and default procedures, including the

- institution of proceedings in relation to any breach or default in respect of any car lease and/or enforcing the security interests relating thereto ('related security');
- 4 responsibility for the safe custody of all documents in respect of the car leases and related security;
  - 5 supervising and collecting payments falling due under the car leases and paying the same into the collection account; and
  - 6 making claims under all relevant insurance policies.

**Arrears and default procedures** The originator has clearly defined procedures for managing leases which move into arrears. These require that the originator establishes contact with the affected lessees at an early stage, in order to establish workable solutions to any financial difficulties which may subsist. BCI London and the borrower will be advised by the originator that as servicer it intends to adopt the same approach to arrears arising from the leases in the receivables portfolio.

**Revocable appointment** The appointment of the originator as servicer and administrator of the receivables portfolio may be revoked if the originator fails at any time to perform its obligations under the servicing agreement. The borrower may in these circumstances terminate the originator's agency and BCI London (as agent for the borrower) will identify an alternative servicer and administrator and in the meantime itself act as servicer and administrator.

**Liquidity arrangements** Due to the particular nature of the widely used Italian direct debit system, (RID) (the receivables paid via the RID procedure increase from 76 per cent to 92 per cent during the life of the transaction), the payments are sometimes effected subsequent to the value date due, still with good value. In order to simplify the administration of such payments, the servicer will provide a liquidity line facility for the part of the receivables to be collected via the RID procedure, whereby on each business day during an interest period the servicer will pay to the collections account an amount equal to the aggregate of the amounts due and payable in respect of the part of the receivables portfolio referred to above, whether or not such amounts are effectively received.

The remaining receivables are paid by payment order or cheque to Auriga when received by Finleasing.

Amounts thus paid but not received by the servicer at least five business days prior to the end of the interest period immediately following that during which such payment(s) has(ve) been effected will be reimbursed to the servicer by Auriga (with interest accrued) at the end of the interest period.

### **The swap agreement**

In order to optimise the management of the cash flow generated by the receivables portfolio and at the same time to eliminate the implicit basis risk (the receivables portfolio is based on prime-rate while the loan is Libor-based), the borrower has entered into a swap agreement with BCI.

### **Credit enhancement**

**The cushion account** On the closing date, Inleasing International Ltd (Inleasing) (a company

duly incorporated and existing under the laws of the Cayman Islands) has placed an interest bearing deposit with BCI London (the cushion account) of an amount of Lit5 billion.

**The letter of credit** The letter of credit (L/C) has been issued by Bayerische Vereinsbank, Milan (LCB) to BCI London in its capacity as lender under the loan agreement pursuant to the L/C agreement under which LCB has undertaken to indemnify BCI for credit losses arising in respect of the receivables portfolio. The aggregate amount of cover under the L/C in respect of losses on the receivables portfolio is 10 per cent of the principal amount of the receivables portfolio.

As repayments of leases are received, the amount of the L/C will decrease proportionately.

### **Credit protection**

Potential investors have to consider the following features, which are designed to give protection in the event of credit losses or late or early payment.

**Receivables portfolio** The investors will bear the credit risk on the receivables portfolio, which will generate the cash flow for the servicing of all payments due under the loan.

The internal rate of return (IRR) of the portfolio is approximately 22.5 per cent p.a. The interest rate applied is fixed, floating or variable upwards if interest rates vary.

The historical loss experience of the portfolio is 1.2 per cent per annum of the annual average portfolio balance during the last three years.

Taking into account present market conditions and the status of the portfolio, the extra cash flow currently available to cover such losses is 10 per cent per annum (the difference between Eurolibor and the current IRR of the portfolio).

Prepayment under the lease contracts is not allowed. However, it is market practice to allow prepayment (on an uncommitted basis), subject to a prepayment penalty fee, if the client requests it.

First-loss protection will be provided as follows:

- 1 in relation to any given quarterly payment, the receivables portfolio's excess cash flow for any quarter date offers further protection for shortfalls and credit losses on individual receivables. Before the cushion account or the L/C may be drawn on, the documentation will effectively require the relevant quarter's excess cash flow to have been exhausted;
- 2 Lit5 billion will be credited to the cushion account on the effective date. This amount represents more than four times the historical losses; and
- 3 a letter of credit of 10 per cent of the principal amount of the receivables portfolio issued by Bayerische Vereinsbank, Milan, will cover any shortfall should the cushion account (which, if utilised, will be replenished with the extra cash flow) be insufficient.

The adequacy of the credit protection should be assessed in the light of the net write-offs of Finleasing's overall portfolio.

**Cushion account** On the closing date the cushion account's balance will be Lit5 billion.

In order to provide additional protection, the amount of the excess cash flow generated from the receivables portfolio after the drawdown date will be available to replenish the cushion account up to the limit of Lit5 billion if it has been utilised to compensate for shortfalls. The cushion account will be drawn to cover shortfalls and credit losses on the receivables portfolio before the L/C can be drawn on. 'Excess cash flow' means, on any quarter date, the excess of



total receivables portfolio income for that quarter over sums required to be paid by Auriga both as priority payments and under the loan agreement.

The balance of the cushion account must be zero before a drawing may be made under the L/C.

**Bayerische Vereinsbank** Rated AAA by Moody's, Bayerische Vereinsbank AG, Milan (BV) has provided an irrevocable standby L/C to cover shortfalls in payments on the receivables portfolio for an aggregate amount of up to 10 per cent of the receivables portfolio's initial principal amount.

The L/C is in favour of BCI London in its capacity as lender under the loan agreement. BV's right of reimbursement under the L/C agreement is against Auriga and is strictly limited to sums deriving from the cash flow.

Sums paid by BV will accrue interest at the rate per annum equal to the three month Euroliure Libor plus 0.75 per cent.

As repayments of leases are received, the amount of the L/C will decrease proportionately.

**Protection for arrears liquidity facility** The servicer has provided a liquidity line facility for the part of the receivables to be collected via the RID procedure, whereby on each business day during an interest period the servicer pays to the collections account an amount equal to the aggregate of the amounts due and payable in respect of that part of the receivables portfolio referred to above, whether or not such amounts are effectively received.

The remaining receivables are paid by payment order or cheque and are paid to Auriga when received by Finleasing.

**Auriga Srl** Auriga, a sole-purpose company, receives the collections on a daily basis and transfers them at same-day value to the swap bank (BCI London) under the swap. By the end of each business day, therefore, Auriga will not have a balance standing to the credit of its own account, but it will have the right to receive on each interest payment date from BCI the sum of the amounts paid to BCI under the swap during the then-ending interest period in order to effect payment under the loan. Auriga therefore carries a swap risk on the swap bank.

As Auriga cannot have any debt, other than the loan and its sole creditors are pursuant to this facility, Auriga can be considered to be a bankruptcy remote company.

Auriga's rights under the various contracts are subject to a fixed charge in favour of the bank.

The exercise of Auriga's rights under the various contracts are vested in officers of Banca Commerciale Italiana.

**Finleasing Italia SpA** Finleasing will have no residual interest in the receivables portfolio, having executed on the closing date a legal assignment duly notified to the lessees.

Finleasing continues to administer and service the receivables and has undertaken to give such time and attention, and to exercise such skill, care and diligence in so doing, as it would have done had the originator not assigned the receivables. Specifically, the originator has undertaken to use all reasonable endeavours to collect payments in respect of the receivables and enforce each debtor's payment obligations according to the terms of the relevant receivable. In collecting and enforcing such obligations, Finleasing observes at all times its customary arrears procedures.

To compensate the originator for providing such services, a servicing fee is payable and is deductible from the receivables portfolio cash flow.

Finleasing collects the payments of the receivables and transfers them at same-day value to Auriga.

In the case of non-performance of Finleasing as servicer, Auriga has the right to appoint a new

servicer. Until a new one is appointed, BCI (or one of its subsidiaries) will act as servicer. Therefore the servicer of last resort is a BCI group company.

**Banca Commerciale Italiana** BCI is the swap bank, the lending bank and the servicer of last resort.

## Notes

<sup>1</sup> The majority of Eurobond issues are generally exempt from any form of withholding tax at source. But individual investors, depending on their country of origin, may find the income so derived taxed in accordance with local fiscal legislation. As far as Italy is concerned, an Italian intermediary used by the investor as its deposittee is required to deduct 30 per cent withholding tax from interest payments received from non-residents prior to payment to the individual investor (Article 26 of the DPR 601, 29 September 1973). Any withholding tax deducted is considered definite and not further taxable if the investor is a private individual. In all other cases income from Eurobonds would form part of the investor's overall taxable income and the investor would be granted a tax credit for the withholding tax already deducted. If the income earned from foreign investments is not repatriated, no withholding tax is chargeable until it is; nevertheless, the income still has to be declared on the investor's annual fiscal declaration (on the investor's option, the bond income may be either taxed separately from the investor's other income, at a definitive rate of 30 per cent, or included in its general taxable income calculations, thereby entitling the investor to claim a tax credit for any tax paid abroad on such income).

<sup>2</sup> The situation is not so clear in the case of a domestic security issue. Depending on how the bonds are ultimately classified, the withholding tax rate may be 12.5 per cent, 30 per cent (as a definitive tax) or 30 per cent (as a tax on account). The general rate of withholding tax deductible at source is in fact 30 per cent, but certain securities are categorised as *titoli atipici*, or atypical bonds, and command a particular fiscal treatment. While in the other cases, as far as corporations and sole traders (*imprenditor commerciale*) are concerned, income derived from investments in domestic securities is included in the investor's general taxable income and a tax credit is given for the withholding tax deducted, income on atypical bonds is excluded and therefore the only fiscal charge is the 30 per cent withholding tax. Certain doctrine (Zucchella: *L'innovazione finanziaria nel credito immobiliare*, Milan, 1988) would support the view that pass-through asset-backed securities would fall into this category. If this were so, it is obvious that asset-backed securities would be extremely attractive for institutional investors wishing to diversify their portfolios into high yielding, low risk and fiscally beneficial investments.

<sup>3</sup> For comparison purposes, the tax treatment of Italian Treasuries and bonds issued by certain supranationals has also been outlined above. It is obvious that private individuals, who are not subject to the same tax regime as corporations (for them the withholding tax deducted constitutes the sole fiscal charge to the income so derived), will continue to prefer securities with lower overall withholding tax rates.

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