Journal of
INTERNATIONAL BANKING LAW

VOLUME 7 ISSUE 9 SEPTEMBER 1992 ISSN 0267-937X

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Foreign Lending to Italian Borrowers: The Legal Framework for Funds Transfer

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Introduction

Most loan capital granted by non-Italian residents to Italian residents (and the relative outgoing in payment of capital and interest) flows via a particular structure called 'conduit'. This structure is used every year for several billions of US dollars and is therefore of considerable interest in the field of international finance. Surprisingly however, notwithstanding the sums involved and the familiarity of the transaction now amply tried and tested and standardised, a general uncertainty exists between banks and operators. There are no directives or case precedents and the fiscal authorities have not issued guidelines. This state of affairs creates an obstacle to the growth of the Italian financial market and the Italian banks often find themselves in the difficult situation of having to explain to the non-Italians that the conduit structure has not received the approval of the fiscal authorities. Everyone is aware of the existence of conduits but it is considered wiser not to discuss them. The situation may be seen as even more confusing if one considers the fact that many Italian state banks and state-owned industrial/commercial companies frequently use the conduit structure.

No doctrine is available on the conduits. The 'silent conspiracy' creates other uncertainties (such as for example, balance sheet treatment of the conduits) which are destined to remain unanswered in view of the preference of not attracting attention to the subject-matter.

In contrast, outside Italy similar structures are discussed openly and official guidelines are issued by the competent authorities.

The scope of this article is to analyse the situation in order to provide a critical breakdown of the form of the conduit and to examine the various aspects which are of interest to the operators.

Description of the Conduit and Fiscal Aspects

The reason for the existence of the conduit is purely fiscal. In order to describe the circumstances of application of the conduit it is necessary to refer to Article 41(a) DPR 22 December 1986 No. 917 which states that interest which matures on a sum given in loan is considered income. If such income is receivable by a non-Italian resident it would be subject to a fiscal withholding as its source is considered to be the country of residence of the debtor.

Article 26 DPR 29 September 1973 No. 600 states that enterprises resident in Italy (that is the enterprises indicated in Article 87 DPR No. 917 which are subject to IRPEG, the Italian corporation tax) have to apply a withholding on interest of 15 per cent which the Italian beneficiary can offset against its future tax due on its overall income. If the recipient is a non-Italian resident or is not a permanent establishment in Italy of a non-resident the withholding cannot be so recovered.

In order to understand the implications of the above legislation it is helpful to take a number of hypothetical situations:

(1) lender non-Italian bank/borrower Italian bank
(2) lender non-Italian bank/borrower Italian company (non-bank)
(3) lender non-Italian company (non-bank)/borrower Italian bank
(4) lender non-Italian company (non-bank)/borrower Italian company (non-bank)

Only in (1) above can the borrower pay interest without having to withhold tax. The second paragraph of Article 26 DPR 29 September 1973 No. 600 states that interest payable by Italian credit institutions to non-Italian credit institutions is exempt from withholding. In all other cases the borrower has the obligation to withhold tax from interest paid to the lender. The latter may be able to recuperate the tax if it is resident in a country which has a double taxation treaty with Italy.

Double taxation treaties generally provide for a tax credit in relation to tax payable by the non-Italian resident in its country of residence up to an amount usually equal to (sometimes less than) the amount of tax paid either directly or by way of deduction in Italy. The actual recovery of the costs suffered because of the withholding depends therefore on the rates of taxation established by the relevant treaty and by the fiscal position of the lender. Even if we suppose that the lender can recover the tax in full, the recovery can only arrive at a later date which necessarily will involve a cost (this cost is termed *cost of carry* and consists of the cost of financing the amount of tax suffered for the period from the date of payment or withholding to the date in which the benefits of the tax credit are received. This period

may exceed one year. In addition if the withholding is in a currency different to the currency of tax credit the lender is also exposed to an exchange rate risk.)

In actual fact, even if there is the material possibility of recuperating the tax paid in Italy, a loan to a resident of the type mentioned in (2), (3) and (4) above is never granted because the implied costs in doing the transaction reduce the overall return to the lender.

In theory, the most common of the situations which can be visualised would be loans granted by parent companies/holding companies to their Italian subsidiaries/controlled companies ((4) above) or by non-Italian banks to Italian corporations in the context of their international activity ((2) above).

However, due to the presence of the withholding requirements the loans listed above are granted by means of a different structure.

What clearly emerges is that the only way to channel capital into Italy without there having to be a tax deduction on the relevant interest flows payable is the interbank loan. For example an American company Alfa Inc. which wants to finance its subsidiary Alfa Italia SpA can – instead of doing a direct lending – deposit the funds with an American bank which in turn lends them to a bank in Italy which in its turn lends them to Alfa Italia SpA. Another example would be the Italian company Beta SpA, which, wishing to diversify its lending banks by means of a syndicated loan, obtains a loan from a bank in Italy which funds itself by deposits placed with it by the banks participating in the syndicate.

Such a structure is, however, seen as unnecessarily complex and is rarely used.

At this point, the conduit presents itself as the best solution. Its structure can be seen as two completely separate phases: while a foreign branch of an Italian bank lends to the Italian resident (non-bank), a non-resident (bank or another company) deposits a sum equal to the amount of the loan with the same foreign branch which has granted the loan and at the same time assumes all the credit risks of the loan.

A foreign branch of an Italian bank benefits from a particular fiscal treatment. On the one hand, as Article 26 DPR September 1973 No. 600 would not be considered applicable, it does not have to make any deductions on the interest payable on the deposits received and on the other hand, it is able to receive interest from the Italian resident gross of withholding as a foreign branch of an Italian bank is considered to be a resident in Italy for (Italian) tax purposes.

Ministerial Circular No. 12 (Finance Minister) of 17 March 1979 deals with this specific aspect. The principle of global income used as a criteria in the directives concerning taxation of Italian residents has been adopted by the Italian fiscal system (Article 95 DPR 22 December 1986 No. 917). The consequence which follows is that income earned abroad by an Italian resident – with or without a permanent establishment in that country – will be included in the calculation of the overall income subject to taxation in Italy. The permanent establishment abroad of an Italian credit institution cannot be regarded as a separate entity. It has nonetheless its own fiscal autonomy, both on an economic and on a managerial level, and the profit generated is subject to taxation in the host country. This, however, does not affect its status of non-resident in the host country. Equally, with reference to Article 20 DPR 917 headed 'Application of Taxation to Non Residents', permanent establishments in Italy of a foreign entity are classified as non-Italian residents. Therefore it is reasonable to assume *a contrariis* that a permanent establishment abroad of an Italian company would be considered non-resident in the host country.

It therefore follows that the income generated by a permanent establishment abroad of an Italian bank in carrying out its industrial activity would be subject to the same fiscal régime as the bank in Italy.

Consequently as the interest received by a foreign branch of an Italian bank in respect of a loan granted to an Italian resident is regarded as industrial or commercial income, Article 26 DPR 600 (interest income) does not apply.

In the hypothetical situation that the lenders are non-Italian banks participating in a syndicate loan or, even more generally, that the lender is a foreign bank wishing to grant a loan in each case in favour of an Italian non-bank company ((2) above), the conduit structure would not be strictly necessary as the lender could be – always having regard to the fiscal implications – a bank in Italy and not necessarily a foreign branch. (If the lender is a non-Italian non-bank company the conduit structure becomes necessary as a deposit with a bank in Italy by such an entity ((3) above) would be subject to withholding of 30 per cent on the interest payable thereon.)

Although the examples in the previous paragraph are fiscally feasible, a bank in Italy in the recent past had an obligation to place with the Bank of Italy reserves in Italian lira calculated on the total of its foreign currency deposit base (Decree of the Ministry of the Treasury, 17 February 1989). This requirement was translated into a cost which the bank passed on to the borrower which had the effect of making the loan uncompetitive in comparison with a loan made by a bank not subject to the reserve. Foreign branches of Italian banks were not subject to this requirement and therefore were in an extremely advantageous position as regards lending in foreign currency in comparison to the Italian branches. Although this reserve requirement has now been cancelled, banks are reluctant to use the Italian branches for conduit because if the reserve is reintroduced it would apply retroactively, that is on the total volume of the foreign currency deposit base. For this reason also the conduit structure via a foreign branch of an Italian bank (and not via a bank in Italy) is utilised for loans of foreign banks to Italian non-bank entities.

In summary, a non-bank Italian resident which wishes to acquire indebtedness abroad and a non-Italian resident which wishes to lend to the former have from a practicable point of view, no option other than utilising a conduit bank. The alternative would be to lend directly and to suffer the withholding, but, as previously mentioned, this would render the transaction uneconomical even in the presence of a double taxation treaty between the country of the lender and Italy which would allow a tax credit to the lender in its home country. As already described the tax credit is not always granted for the total of the withholding paid and even if such was the case, the benefit would be postponed with not insubstantial economical implications.

Legal Structure

The conduit is made up of two separate legal contracts: one evidences the loan between the foreign branch of an Italian bank and the Italian resident and the other evidences the deposit between the foreign branch and the non-resident.

The law which governs both contracts is normally English law.

The transaction is, at times, erroneously likened to a loan collateralised by cash or to a guaranteed loan in which the guarantor deposits the amount of the loan and concedes the right to compensate the deposit with the guaranteed loan.

As far as the first of these is concerned, the similarity becomes difficult due to the absence of willingness of both parties (depositor and foreign branch) to create a security.

The intention of the non-resident is to grant a loan to a resident but as this would have adverse implications under the current Italian fiscal legislation, he prefers to make a deposit the repayment of which depends on the solvency of the borrower. The intention of the bank is to offer a service of intermediation. The non-resident is ready to assume all the credit risks under the loan which the bank makes to the resident and the bank instead does not want to assume any risk of the resident. If the conduit were reconstructed as a loan guaranteed by cash the foreign branch would be exposed to the risk of revocation of the guarantee in the case of insolvency of the non-resident.

In addition another argument against the possibility of construing the transaction as a guarantee stems from the absence of any form of notification foreseen under English law for such guarantees. In fact a legal charge on a deposit would require registration. An equitable charge, which on the other hand would not require registration, would not satisfy the scope of the lending bank in that the charge would not be enforceable against third-party creditors of the guarantor or to a receiver in the event of insolvency. Consequently the conduit bank would find itself exposed to the risk of having to pay back the amount granted as security and would have to wait for the maturity of the loan to be repaid, having to bear all the credit risks of the borrower.

In addition it must also be remembered that if the depositor is a bank, the supervisory authorities often do not consent to the creation of preference on its activity assets (loans) except in particular cases.

Another argument is raised by the fact that often the banks which participate in a conduit transaction are not the smaller ones but the major ones who have – as part of their funding – contracted Eurobond issues or Euroloans both ordinarily subjected to English law. Normally such contracts contain a negative pledge clause by which the bank who receives the loan or issues the bonds agrees not to grant preferences or create security on its assets. The creation of a charge, be it legal or equitable, would constitute a breach of such contractual charge.

It is evident for the above reasons that the construing of a conduit as a loan with cash security will not find any grounds in law.

The construing of the relations between the non-resident and the conduit bank as a guarantee together with a deposit which can be compensated with the guaranteed loan in the case of insolvency of the resident borrower lends itself to the same type of objections listed above as the conduit bank would find itself exposed to the credit risk of the resident whenever third-party creditors of the depositor obtained the attachment or the sequestration of such deposit or the depositor became insolvent. In this last case as the foreign branch would not have any preference over the deposit, it would receive receivership funds as a creditor by means of guarantee.

The correct construction leads us to a simpler structure. The conduit loan contains only one characteristic (except for what will be explained later on) which distinguishes it from a normal loan and that is a contractual clause by which the bank is obliged to grant the loan subject to the condition of having received a corresponding amount from the depositor. In other words the obligations of the foreign branch are subjected to a condition precedent of receiving the deposit from the non-resident more or less specified.

For international syndicated loans the depositing banks are precisely listed while for a loan between parent and Italian subsidiary the reference may be more or less explicit according to the documentation used.

The formulae normally adopted are of the following tenor:

> The Bank shall not in any circumstances be obliged nor liable to make available to the Borrower any sum greater than the amount received from the Depositor,

> as defined in a Deposit Agreement dated . . . between the Bank and . . . (the 'Depositor') pursuant to the provision therein contained,

or

> The Borrower acknowledges that the Bank may fund or match the facility in whole or in part in any manner whatsoever and may enter into the Funding Agreements and that the Bank will be bound by the Funding Agreements. If the Bank elects to fund or match the facility entirely by means of Funding Arrangements in respect of the entire facility, the Bank shall not be obliged to seek alternative sources of funds or use its own funds if for any reason the Funding Agreements do not enable the Bank to satisfy any request or demand made by the Borrower pursuant to the facility.

The relations between the non-resident and the conduit bank consist in a contract of a term deposit, the repayment of which (and the payment of relative interest thereon) is conditional on the solvency of the resident borrower or more precisely on the fact that the resident fulfils all of its payment obligation under the loan granted by the conduit bank.

The depositor bears all the credit risks relative to the loan and the bank with this structure is not exposed to credit risks. In fact third-party creditors of the depositor can obtain rights of preference, sequestration attachment and so on of the deposit but they cannot expect prepayment prior to the maturity originally agreed as the *beneficio del termine* (literally 'benefit of the time', which means that the postponement is set in the interest of the lender) is in favour of the lender. In addition the reimbursement of the deposit (or the payment of the relative interest) is subject to the receipt of the amount due from the borrower. If the latter is in default, the bank will not be required to reimburse anything.

The clauses normally used are in the following tenor:

> The Depositor unconditionally agrees that on each date on which the Bank is obliged to make any amount available to the Borrower pursuant to the terms of the facility, in order to enable the Bank to make such amount so available, [it] will make a deposit with the Bank for such period as such amount shall be outstanding according to the terms of the facility in the currency in which such amount is required to be made available. Whenever a repayment of principal or a payment of interest is received by the Bank from the Borrower under the facility, the Bank shall forthwith pay the same to the Depositor by way of repayment of principal or payment of interest on the deposit. The Bank will not under any circumstances be obliged nor liable to pay to the Depositor an amount in excess of the corresponding amount received by the Bank from the Borrower under the facility.

The conduit structure, at times, can be inserted in a wider relation of mandate whenever a non-resident (ordinarily a parent company of an Italian company) requests a foreign branch of an Italian bank to grant a loan against the prior receipt of the relative funding.

The mandator and its creditors cannot have any claim on the sum originally transferred to and utilised for the execution of the mandate. The conduit bank is protected against the insolvency risk as the obligation to reimburse the deposit (and to pay interest) to the mandator only arises if and to the extent that the resident reimburses. The funding relationship takes the form of the deposit with a conditional repayment analysed previously.

The depositor does not have any contractual relationship with the borrower, does not benefit from any right against it and in the event of insolvency of the borrower cannot take action for the recovery of the debt nor can it exercise any legal action which are the rights of the conduit bank. The latter, in order to leave a minimum of control to the depositor, who, faced with the inability of the borrower to pay, would find itself unable to recuperate the debt, commits itself to take any legal action agreed with the depositor.

In case of non-payment by the borrower the conduit bank, as has been explained, has no obligation to repay the deposit as the condition to payment has not been satisfied. The conduit bank will exercise legal actions in order to preserve its own rights and will repay the deposits to the extent of the amount that it will be able to recover.

If the credit is not recuperable in whole or in part (or the time necessary to obtain repayment is very long) the conduit bank would be freed from its obligations only when there is the certainty that the 'condition' can no longer be fulfilled. This solution, however, would be too radical and could fuel controversies in connection with the impossibility or otherwise to be able to fulfil the condition and as such is not used by the market.

The practice has evolved two diverse mechanisms to free the bank in the case of insolvency of the borrower.

The first consists in the right of the conduit bank to assign the credit to the borrower obtaining in exchange the freeing of its own debt deriving from the deposit. In other words the remission of the debit ex-deposit is the price for the assignment of the defaulting credit.

The second mechanism is more complex and involves three phases:

> (1) the granting – at the same time as the creation of the deposit – by the depositor in favour of the conduit bank of an indemnity with which the depositor commits to indemnify the bank against any losses which could result from a default by the borrower;
> (2) the right of the bank to compensate the credit towards the depositor in the event the same is obliged to pay, pursuant to obligation (1)

above, to the bank certain sums against the debit ex-deposit of the bank;
(3) the right of subrogation of the depositor in the position of the bank.

In other words, the depositor by extinguishing the obligation (1) above – cancellation which is activated not by fulfilment but by the compensation with its credit ex-deposit – satisfies the credit which the bank has towards the borrower and at the same time is subrogated in the position of the latter.

The same result is obtained by the first mechanism with the difference that the assignment of the credit does not presuppose a payment while the subrogation is activated by means of payment *sine animus solvendi alieni debiti* (without the intention of extinguishing the debt of the borrower). The absence of willingness to cancel the debt of the borrower is evident insofar that the depositor does not want to exercise the right of regression (which he would have if he had cancelled the debt ex-loan) against the borrower but wants to succeed to the position of creditor in order to be able to control directly the debt collection.

Conduits and Subparticipation

In order to understand more fully the characteristics of the conduit transactions it is useful, at this point, to compare the structure to that of the subparticipation for which there now exists a large market. The transaction can be summarised as follows:

A bank, after having granted a loan, decides to liberate itself from the relative risk for various reasons which may relate for example to respecting certain internal units or country limits, the necessity to satisfy certain capital ratios imposed by central banks and so on.

The bank sells the loan to another bank who is able to take a risk which it would not have been in a position to assume directly not having, for example, a relationship with the borrower.

The forms by which a transfer of the risk can be performed are normally three: assignment of the credit, novation and subparticipation.

The first two usually require the approval of the debtor while the latter form of transfer may be made without notification. This characteristic simplifies greatly all the aspects of the transaction which is the cheapest form and the most used, enhancing to a great extent the liquidity of such credits. From the legal point of view the subparticipation and the conduit have the same legal structure. In fact in both transactions a bank grants a loan and receives from a third party a term deposit the repayment of which (and the payment of the relative interests) is conditional on a future and uncertain event occurring which is the receipt by the lending bank of certain sums payable by the borrower.

An official description of the subparticipation has been given by the Bank of England with its document on 'Loan Transfer and Securitisation' of July 1989 in which it describes the subparticipation as follows:

> . . . the term subparticipation is not a term of art as a matter of English Law. Rather, it is a market expression applied to the 'sale' of a loan by way of a back-to-back non-recourse funding arrangement: the buyer deposits a sum of money (equal to the whole or part of the underlying loan) with the seller on terms under which the moneys are repayable (and interest is payable) if and only if the seller receives payments of principal (and interest) from the underlying borrower, and subject to a maximum of the amount received. The sub-participation, as customarily documented, is a separate legal agreement from the underlying loan, creating a debtor-creditor relationship between buyer and seller. The buyer does not acquire any legal or beneficial interest in the underlying loan, nor any contractual relationship with the ultimate borrower. In consequence, in contrast to novations and assignments, the buyer does not have any direct recourse to the borrower and is not able to exercise any of seller's rights against the borrower.

One can state that a conduit loan is none other than a subparticipation created from the start and a subparticipation is a conduit created afterwards.

The two structures remain, however, very distinct in that the scope of the conduit is to render fiscally possible a loan otherwise not available while a subparticipation is the instrument by which loans are sold and transferred on the international market.

The teleologic and genetic difference (between the moment in which the loan is made and the deposit) between the two structures involves differences in the legal nature of the relationship between the parties.

In fact a normal loan contains a series of standard clauses in favour of the lender such as (1) the Illegality Clause giving the right to the lender to request the early repayment of the loan should such become illegal as a result of change of directives or legislation; (2) the Increased Costs Clause which requires the borrower to pay to the lender certain sums if necessary to compensate for additional costs or foregone profits owing to the introduction of new laws, directives, taxes and so on; (3) the Grossing Up Clause which commits the borrower, in the event that it is necessary to withhold an amount in respect of tax, to increase the amount owed to the lender such that the payment net of taxes is the same as the amount which would have been receivable in the absence of taxation; and (4) the Market Disruption Clause and Substitute Interest Rate Clause

which protect the lender in the event of difficulty of obtaining funds or determining the interest rate applicable.

The conduit loan by definition is made at the same time as a deposit is placed by a third party who assumes the risk of the loan with the bank; for such a reason this contract tends to guarantee the depositor the same clauses agreed for the lender. The reasoning behind this is to put the depositor in the same position which it would have if it had lent the loan directly and as such normally would enjoy from the same benefits of the lender (for example, all the above-mentioned clauses are also extended to the depositor).

In a conduit loan are found, in fact, certain agreements in favour of third parties which are outside the relationship of the loan.

From a legal point of view the borrower of a conduit loan is exposed to greater risks than it would be with a non-conduit loan. In the same way, the depositor of a subparticipation finds itself in a riskier situation than the depositor in a conduit transaction. For example, if a new taxation is introduced with respect to the deposit of a depositor, reimbursement of the costs for this can be obtained from the borrower if the loan is conduit – otherwise the depositor would have to absorb the cost without possibility of requesting the early repayment of the deposit. Or else if the hypothesis of an increased cost situation arises only for the depositor, the borrower will not be under an obligation to reimburse the increased cost if it is a loan subject to subparticipation, while this obligation exists if the loan is conduit.

It is worth while remembering that the depositor is in both cases (conduit and subparticipation) exposed to a double risk – (1) the insolvency of the borrower and (2) the insolvency of the bank.

In fact in the case of insolvency of the bank the depositor will be paid as any other unsecured creditor notwithstanding the punctual fulfilment by the borrower of its payment obligations.

Conduits and the Role of the Agent in Syndicated Transactions

When the borrower of an international syndicated loan is an Italian non-bank company, a foreign branch of an Italian bank takes the role of conduit; on one side it signs directly the loan contract and on the other it signs a deposit agreement with the various banks participating in the syndication.

If the borrower is an Italian credit institution, only one agreement is signed between the borrower and the various lenders as the conduit structure is not necessary (see above).

The obligations of the participating banks are not joint, rather they are several, such banks being under obligation pro rata to the amount of their participation and the failure on the part of one bank to honour its commitments does not free the remaining banks from their responsibilities neither does it render them responsible for such failure. Each bank is free, in addition, to act directly against the borrower to preserve its individual rights.

The clause normally used reads as follows:

> The Banks agree to lend to the Borrower upon and subject to the terms of this agreement the sum of . . . The obligation of each Bank shall be to contribute that portion of each advance which its commitment represents of the total of the commitments of all the Banks. The obligations of each Bank are several; the failure of any Bank to perform such obligations shall not relieve any other Bank or the Borrower of any of their respective obligations or liabilities under this agreement nor shall any Bank be responsible for the obligations of any other Bank. Notwithstanding any other term of this agreement the interests of the banks are several and the amount due to each Bank is a separate and independent debt. Each Bank shall have the right to protect and enforce its right arising out of this agreement and it shall not be necessary for any Bank to be joined as an additional party in any proceedings to this end.

From a practical point of view it would be, however, rather complicated if each administrative relationship between the lenders and borrower were to be administered independently. For example, for repayment of a capital instalment and the relative interest the borrower would not only have to calculate the portion due to each lender but would have to execute as many payments as there are lenders: each notification in relation to the loan would have to be multiplied by the number of lenders.

For reasons of practicalities and expedition for this type of transaction, there exists an agent which exercises the role of co-ordinator between the banks and the borrower.

The agent is nominated by the lenders and operates on their behalf on the basis of a mandate insofar as the payment obligations are concerned. All the payments, be they those of the banks to the borrower or those of the borrower to the banks, are effected through the agent.

The agent in addition assumes various obligations of an administrative nature with regard to the banks, for example to transmit to the lenders all documents received from the borrower, to inform each depositor in good time of the amounts requested by the borrower indicating the share of participation of each, to effect all the calculations under the loan, to exercise legal action which would eventually be decided by the lenders and so on.

The clause normally used is as follows: 'Each Bank authorizes the Agent to exercise on its behalf

the powers specifically delegated to the Agent herein and all other powers reasonably incidental thereto.'

From the practical point of view the activities carried out by the agent and by the conduit bank are identical. The duties exercised and the actions taken are the same; what is different is the legal basis which governs the duties. The conduit bank is creditor and has full title against the borrower and against this credit exist similar amounts in deposit (except the relative quota of risk which the conduit bank is willing to take) while the agent in such capacity has no title against the borrower except for within the limits in which it acts on behalf of the depositors.

Balance Sheet Treatment

The author will now analyse how the conduit transactions are reported in the balance sheet.

The conduit bank reports the whole loan among its assets and the deposits in the liabilities (as a selling bank of a subparticipation would do).

The depositor on the other hand does not report a credit towards the lending bank but evidences the risk of the borrower as it bears on the whole of the credit risk of the loan. The obligation of the repayment of the deposit (and the payment of the relative interest) is subject to the occurrence of the uncertain future event that the lending bank receives a certain sum from the borrower.

Analysing the situation, there is no duplication as such; there are found to be two types of relationship – one due to the loan which is evidenced on the asset side of the balance sheet of the conduit bank and on the liability side of the balance sheet of the borrower and the other from the deposit which is evidenced on the liability side of the conduit bank. The depositor reports the credit towards the subject on which the fulfilment of the obligations of the lending bank depends.

However, there is another approach which consists in evidencing the conduit loan and conduit deposit among the contingent liabilities. The accountancy profession, in fact, tends to make substance prevail over form and in laying out a balance sheet, aims to represent as far as possible the real situation. It is with this view that some Italian banks evidence the conduit loans among the contingent liabilities.

For example, Article 10 of Directive 86/635 of the EC Council of 8 December 1986 on the one hand confirms that 'funds' which a credit institution manages in its own name but for account of others have to be reported in its balance sheet only if the institution is owner of the related activity (as in the case of conduit loans) while on the other hand it established that nevertheless the Member States may permit these funds to be reported off balance sheet, if a particular régime exists which allows the exclusion of such sums from the creditor's funds in the event of liquidation or of an analogous event of the credit institution.

In other words if in the deposit agreement (or in the subparticipation agreement) a clause exists which allows some type of privilege in favour of the depositor (or the subparticipant) on the loan or if the institution with which the deposit is made carries out the role of trustee of the depositor (or the subparticipant) thc Member States could allow the loan to be taken off balance sheet of the bank with which the deposit is made.

Also relevant in this context is the recent document headed 'Statement of Recommended Accounting Practice on Off-balance Sheet Commitments and Contingencies' published by the British Bankers Association on 23 October 1989. Paragraphs 52 and 53 of this document point out that 'a washable loan is a loan which is secured by a matching deposit under an arrangement which meets the criteria for a legal right of set-off'. The washable loan can be distinguished from a conduit loan by the fact that in the latter compensation between loan and deposit does not arise (eventually conduit bank compensates the credit deriving from the indemnity with the debit deriving from the deposit). As can be noted the British Bankers Association has acknowledged that a loan guaranteed (not necessarily in the technical legal sense) by a deposit with an underlying compensation agreement can be excluded from the balance sheet.

Additionally the British Bankers Association is preparing a recommendation in connection with treatment of loans and has forewarned that the official position will almost definitely be taking conduit loans off the balance sheet (and loans granted in subparticipation).

Although it may seem obvious it is worth mentioning in conclusion that an agent bank evidences in its balance sheet only its own share of the participation in the loan. In this connection the Directive 86/635 of 8 December 1986 of the Council of the European Communities establishes that in the case of loans granted by a consortium which reunites various creditors, each entity which participates in the syndicate has to indicate only its own share of the total amount of the loan (Article 9).

Conduits and Capital Ratios

The setting of a standard level of capital which each bank has to maintain against risks connected with its

activity has been the aim of the regulatory authorities of the principal countries and of various international institutions in the last few years.

To such aim, loans effected by each credit entity are not considered in the same way by reference to capital against it but are differentiated qualitatively by means of a weighting as a function of that risk. Each item on the balance sheet is multiplied by a risk ratio of between 0 per cent and 200 per cent depending on the regulatory body. The result consists in a value attributed to each activity in order to calculate the minimum capital to put against it.

With this aim the Italian Interministerial Committee for Credit and Saving (CICR) with its paper of 23 December 1986 has established the fundamental principles for the introduction of minimum capital adequacy ratios of a general nature to which would be correlated the granting of loans, keeping in consideration the various types of risk and delegating the Bank of Italy the task of defining the directives of application.

The Bank of Italy with its circular of 4 April 1987 introduced *inter alia* a minimum capital adequacy ratio connected with corporate risk.

At the same time the central regulatory authorities of G10 have delegated the Committee on Bank Regulations and Supervision acting under the aegis of the Bank for International Settlements to redirect a proposal for the harmonisation of the capital requirement which the banking institutions would have to respect in carrying out their activity. The result was a consultative paper commonly known as the Basle Accord. On 15 July 1988 the Committee published a revised version called 'International Convergence of Capital Measurement and Capital Standards', containing the results of the reflections and the changes suggested and made necessary by the fact that the regulations are applicable to profoundly different banking systems. The text thus arrived at constitutes the current basis of reference for the Regulatory Authorities of the G10 countries. Each of these has to make operative the Basle Accord in its own country and in so doing can operate a certain amount of discretion.

The first central bank which issued applicable guidelines was the Bank of England in October 1988. Being the first in this sense and in consideration of the cultural authority of the English central bank, this certainly had considerable influence on the position of the other central banks.

The necessity to impose common rules on this important point has also been felt at EC level. In this connection the EC Council issued on 17 April 1989 Directive 299 on Own Fund in Order to Calculate Capital Basis and a second directive on 18 December 1988, Directive 647, which regulates liquidity ratios.

However, none of the above documents actually deals explicitly with conduit transactions. The treatment of the conduit transaction has to derive from interpretation of the rules introduced.

The circular of the Bank of Italy of 4 April 1987 introduced a form (134 Vig) in which has to be reported the capital ratio relative to corporate risk. The only factual evidence which results in the exclusion of the conduit transaction from the list of assets which together form the capital employed is found in the instructions to complete the form. Note 7 states that: '. . . as far as loans made with third party funds in administration are concerned, only the portion belonging to the bank will be disclosed'.

More determining in the author's view is the basic underlying reason of the notification. The aim of the Bank of Italy is to check if capital is sufficient to cover the existing risks. It is necessary therefore that the form reports the situation corresponding as far as possible to the actual situation regarding risks which do not appear on the official balance sheet and eliminates on the other hand non-existent risks. As the conduit loan is free from risks the bank does not have to include them among its assets. If it were not like this the capital ratio of the institute in question would be falsified with the calculation of fictitious risks.

A more determining reason is provided by the Bank of England: the Basle Accord states that a zero risk ratio is given to claims collateralised by cash where the term 'collateralised' does not mean 'guaranteed' in the technical juridical sense. The same provision can be found in the implementation directive of the Bank of England. The Bank of England interprets the claims collateralised by cash as including not only the loans guaranteed by a charge on cash but also the loan against which a deposit is made the repayment of which is conditional on repayment of the loan itself.

From this results that the conduit attracts a zero ratio and does not involve capital costs for the lending bank. In other words the Bank of England considers the conduit transaction free of risk for the lending bank. In addition the Bank of England published on 3 February 1989 its 'Notice on Loans Transfer and Securitisation'. This document states that 'where a loan is funded in whole or in part via a subparticipation, the Bank will recognize the transfer of credit risk by excluding it (or the relevant part) from the original lender's risk asset ratio, and including it in the sub-participant's as a claim on the underlying borrower'.

As previously stated the subparticipation and the conduit have the same juridical structure (deposit the repayment of which is conditional) and therefore the above notice constitutes a second official – albeit indirect – confirmation of the non-existence of the risk in the conduit transactions within the scope of the Regulatory bodies.

The positioning of the Bank of England is of fundamental importance as it is the first official position taken, even though only on an interpretive level, of the riskiness of such a structure. Should the Bank of Italy, which has issued the convergence guidelines for the Basle Accord without touching on this point, assume a different position, that is apply a risk coefficient other than zero, it would create a cost in the form of capital for the conduit transactions. Such cost would be passed on to the end-users (the depositor and/or the borrower) and would seriously penalise the capital flows in Italy.

It can be reasonably foreseen that in consideration of what has been analysed in this article and in particular the absence of risk in the conduit transaction and the primary importance this has for the Italian economy, the regulatory body will set a zero coefficient for the conduit transactions.

Conclusion

In this article the aim has been not to produce solutions but only to describe the product and the relative problems from many points of view.

If the conduit is classified as a lawful form, as one is led to assume from the attitude of the fiscal authorities and all the participants involved, there is no reason to maintain a silence of the press on the theme. Rather a clear position taken by the fiscal authorities in the favourable sense would result in notable benefit in terms of image and confidence of Italy.

If, on the other hand, the transaction was seen in an adverse manner and in particular the conduit in which the depositor is the parent company of an Italian company which borrows the loan, it would be necessary to face the (tragic) reality.

Quae publice fiunt, nulli licet ignorare! (It is not proper to ignore things which are done publicly.)