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APPROFONDIMENTI

Draft Law no. 843 and the distorting effect on the Italian NPLs market

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1. Background on the non-performing loans market

In the last few weeks, press articles (such as "*Sole 24 Ore Plus*" dated 12 August 2023 "*Npl. Sui crediti inesigibili la palla ora passa a Urso. Il Mimit pronto al decreto*"; "*la Repubblica*" dated 15 August 2023 "*Ricomprare i debiti deteriorati, un decreto per famiglie e Pmi*"; and "*Bloomberg*" dated 24 August 2023 "*Italy's New Rules on Bad Loan Sales Could Be Another Blow to Investors*") have given renewed focus to the examination, currently underway at the VI Finance Commission of the Italian Parliament, of the draft law entitled "*Disposizioni per agevolare il recupero dei crediti in sofferenza e favorire e accelerare il ritorno in bonis del debitore ceduto*" issued for parliamentary consultation on 31 January 2023 (hereinafter, the "**Draft Law**").

Such renewed attention stems from the provisions of the Draft Law, as well as those of other similar draft laws proposed in the past (*e.g.* draft law No. 788 of 2018 and draft law No. 414 of 2022 (the latter – equivalent to the Draft Law – similarly assigned to the VI Finance Commission on 14 March 2023, but not yet examined)), having been examined by the Italian Council of Ministers in the course of its drafting work during the month of August on Law Decree No. 104 of 10 August 2023 (the so-called "***Omnibus Decree***"), in which the above-mentioned measures were supposed to be included. Amongst others, opposition parties additionally presented draft law No. 1246 of 23 June 2023 entitled "*Disposizioni per favorire la definizione transattiva delle posizioni debitorie classificate come crediti in sofferenza o inadempienza probabile",* likewise assigned to the VI Finance Commission on 1 August 2023. This proposal, which has not yet been examined, despite differing from the Draft Law in certain respects (*e.g.* the parties involved, the timeframe), is nonetheless based on the same principle as the Draft Law, as it provides for the debtor's right of option to repurchase its debt according to pre-determined conditions.

However, these measures have not at present been included in any decree and, according to what is reported by leading newspapers, they will be re-discussed by the Italian government and possibly translated into law or included in the 2023 *Budget*

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Law. Moreover, in order to discuss these measures, also given the complexity of the matter, it is noted that the convening of a technical table for the current month of September (the "**Technical Table**") is under consideration.

As further detailed below, the measures under examination would give the debtor, in the event of the assignment of the relevant receivables, the right to extinguish – under certain conditions – one or more of the assigned debt positions, this also to the detriment of transactions already concluded and based on binding agreements (with obvious repercussions also on the whole capital market).

It is worth pointing out that the Draft Law has alarmed sector operators and the capital market, concerned by the impact that the measures in question could have on the non-performing loans market, characterized (i) by a high volume of non-performing loans under management (over EUR 300 billion of gross portfolio value); (ii) the intervention of multiple players (originator banks, credit assignee companies, servicing companies, rating agencies, assigned debtors, investor entities (national, including also Italian banks and small local investors, and international)), each of which has its own interests; (iii) by complex transactions based on complex valuations (carried out by all the parties involved), in which the purchase of NPLs is often carried out through securitisation transactions and purchase tenders; (iv) from the close interaction with the capital market (*e.g.* securitisation transactions with ABS securities placed on the market - including, for example, transactions with senior ABS securities covered by an Italian State guarantee (hereinafter, the "**GACS Transactions**")).

If the Draft Law were to be approved, it would have a distorting impact on the NPLs market, , not least by affecting already established private arrangements with the risk of destabilizing the management and recovery system of such receivables, which in most cases is entrusted by the assignees of such non-performing receivables to specialized professional operators (*i.e.* servicing companies) under management contracts (*i.e.* servicing agreements). The Draft Law would affect the operativity of servicing companies, with legal and commercial effects on existing servicing agreements, resulting in serious damage and affecting one of the strategic sectors of the Italian system. In this regard, it should be noted that the receivables servicing market as well as the Italian credit collection market (which involves more than 1000 companies) has grown enormously in Italy in recent years, with more than 35 merger and acquisition transactions involving such operators (including acquisitions and joint ventures) having been carried out from 2008 to 2022. In addition, it is estimated that (as of today) the top 7 servicing companies manage nearly €300 billion (in terms of gross book value) of non-performing receivables.

2. Discipline and Scope

The Draft Law would seemingly grant the debtor, in the event of the assignment of the relevant receivable by banks or financial intermediaries, the right to extinguish one or more of the assigned debt positions by paying to the assignee the purchase price of the relevant receivable (to be calculated pursuant to the provisions of article 2 of the Draft Law), increased by 20% or 40% (as the case may be)(hereinafter, the "**Discharge Payment**"), up to a maximum limit of Euro 25,000,000.00 (calculated on the nominal value of the assigned loan) (hereinafter, the "**Option**"), provided that the assignment took place by 31 December 2022 (which would obviously negatively affect transactions already concluded and the agreements entered into thereunder between private parties).

Upon payment of the debt, the automatic deletion of the non-performing debt position from the Central Risk Register of the Bank of Italy would then then granted.

More specifically, the Option would apply to receivables:

1. whose debtor is a natural person or an SME;
2. whose assignor is a bank, or a financial intermediary registered in the register referred to within Article 106 of the Italian Consolidated Banking Act – thus excluding the applicability of the provisions of the Draft Law to assignments made

by securitisation vehicle companies established pursuant to Law No. 130/1999 (the "**Law 130**");

3. classified as "*impaired*" (including, therefore, also probable defaults or "*unlikely to pay*") between 1 January 2018 (2015, on the other hand, pursuant to draft law No. 414/2022) and 31 December 2021;

4. transferred – including as a part of securitisation transactions – by banks or financial intermediaries by 31 December 2022.

In order to allow the exercise of the Option, the Draft Law provides for a general obligation of the assignor and the assignee – without specifying, however, on whom this obligation actually falls – to notify the relevant debtor of the transfer and the price paid, within 10 days from such transfer (or, in the case of transfers that have already occurred, 30 days from the entry into force of the Draft Law) (the "**Notice of Transfer**") and, failing that, the assignee would be unable to proceed with enforcement or precautionary actions on the debtor's assets.

In other words, the assignor and the assignee involved would be burdened with the onerous obligation of notifying a considerable number of assigned debtors – especially considering the volumes of the NPLs receivables transactions– of the assignment, with practical and economic impacts of no little importance.

In addition, pursuant to the Draft Law the debtor would, within 30 days of receipt of the Notice of Assignment, have to notify in writing:

- the will to exercise the Option; and,

- the commitment to make the Discharge Payment within 90 days (or a different term agreed between the parties),

on the basis of terms that appear evidently insufficient, if considered in relation to parties that are already in default and that would likely be unable to find the sum necessary to cover the Discharge Payment within 90 days.

3. The Bank of Italy intervention

The impact that the measures under discussion would have on the non-performing loan market have already been highlighted by the Bank of Italy which, in its memorandum of 18 March 2020 (updated as of 30 September of the same year) in relation to draft law No. 788 of 2018, warned the legislator about the possible distorting effects that such measures could generate.

In particular, the Bank of Italy had already noted that, *inter alia*, such measures could:

- expose the assignee to a long period of uncertainty – pending the debtor's exercise (or not) of the Option – before being able to consider the purchase transaction "stable" (especially considering that it is not possible to make forecasts on the number of debtors effectively exercising the Option);

- cause higher costs (than those estimated) to be borne by the assignees and deriving from the fulfilment of disclosure obligations to the large number of assigned debtors (even higher in securitisation transactions);

- have distorting effects on the debtors' behaviour, which may be induced to strategic defaults by considering it more convenient not to pay the debt while taking advantage of the Option at a later stage.

In light of these considerations, the Bank of Italy suggested excluding from the regulatory framework assignments of receivables already entered into in order not to *"[…] alter considerably the negotiating balance – and, in particular, the pricing structure – of transactions already completed*" and to avoid, in the context of securitisation transactions, the lowering of the value of receivables consequent to the exercise of the Option could alter *"[…] the risk/return profile of the securities issued, penalising subscribers and compromising the reputation of this market in Italy*".

4. First systemic remarks

The above considerations form the basis for our first systemic remarks:

i. Knowledge of the non-performing loans market

From a reading of the Draft Law, as well as from the preamble to draft law No. 414/2022, it appears desirable that the legislator further investigates the real characteristics and operating methods of the non-performing loans market.

As previously mentioned, the purchase of non-performing receivables, often carried out through securitisation transactions, is based on valuations, assumptions and pricing models that consider various elements (*e.g.* recovery prospects, loan management costs, the status of the receivables (how it has been managed, any guarantees backing it, etc.). The combination/modelling of these items (and further items analysed by investors during the due diligence phase) determines not only the price offered by the investors for the purchase of the receivable, but also the drafting of the business plan that reflects the expectations and the timeframe for the recovery of the receivables forming part of the portfolio.

It is evident that the provision under discussion, together with its retroactive effect, completely compromises the analyses carried out by investors by introducing an element (certainly of no little importance), which if known *ab origine* by the investor would have led to a different determination of the price or to a different organisation of the recovery activities.

Moreover, it should not be disregarded that both assignors and assignees, although bearers of different (but not necessarily opposing) interests, do not act on unequal positions, and to reduce the discussion to investors who, as stated in the explanatory memorandum of Draft Law (*Disegno di Legge*) No. 414/2022, *"[…] take advantage of it, with profit margins that could be defined as usurious*", appears extremely simplistic.

The assignee, in fact, is selected by the assigning parties – generally in the context of a competitive procedure in which several bidders participate – precisely on the basis of the best possible offer, formulated, moreover, also taking into account of the relevant costs necessary to evaluate the receivables, being a complex and delicate operation that requires time, due diligence, and know-how. It is not understandable, therefore, how profit margins can be defined as usurious, which on the contrary reflect the difficulties of managing the individual portfolio, as well as the costs of analysing the same.

In addition, it is necessary to consider that the selling banks, far from being crushed by investors, have a wide margin of appreciation in choosing the purchaser, considering that such portfolios are offered to several investors, leaving banks free to choose the highest bidder. Moreover, it should be borne in mind that, in practice, such sales only take place when the bank considers the terms offered to be advantageous, and it is not uncommon for certain sales procedures to end uncompleted.

Finally, the provisions regarding the notification requirements associated with the exercise of the Option also appear to be inconsistent with the market. As previously highlighted, the non-performing receivables market is characterized by the presence of a high number of debtors (and concentrated in single transactions). It would seem impossible, therefore, to assume that servicers would be able to communicate the price of the relevant receivable to all debtors in just 30 days, especially considering that very often, certain contact details, to which to make notifications or communications, are not available to servicers. In addition, there would be considerable costs involved in this activity.

ii. Aspects of constitutional legitimacy

The Draft Law – although it would seem to refer also to future assignments – currently involves only assignments of receivables that have already taken place, thereby affecting consolidated private agreements. This would obviously require an examination of the compatibility of the provisions under consideration with the principle of non-retroactivity of laws. This principle – which is expressly sanctioned only with reference to criminal laws – is, however, also accepted in other sectors of our legal system, although in a mitigated manner, being substantiated by the balancing, in the event of the enactment of retroactive laws, of the constitutionally relevant interests of the community with the general principle of reasonableness, equality and the protection of the legitimate expectations of private parties.

On the other hand, it is precisely the principle of legitimate expectations that plays a pivotal role in the promulgation of retroactive laws, particularly in light of the growing importance attributed to it by the Italian Constitutional Court, which is increasingly closer to the European Court of Human Rights (which, precisely on the basis of such principle, has always had a less permissive attitude towards retroactive laws). This legal concept - defined by the Italian Constitutional Court as a "*fundamental and indispensable element of the rule of law*" (Cort. Cost. No. 16, Jan. 24, 2017) - should be construed as the citizen's right to legal certainty, including the holding of agreements made in the context of private negotiating autonomy, which cannot be compromised by the application of legislative measures that affect the negotiating balance of agreements entered into by private investors, in the face of high investments and their expected returns.

Moreover, the limitation of the applicability of the provisions only to certain active parties (banks or financial intermediaries – thus excluding securitisation special purpose vehicles), as well as to passive parties (only certain categories of debtors), gives rise to unjustifiably discriminatory treatment contrary to the fundamental constitutional principles of our legal system.

iii. (Retroactive) impacts on transactions and the capital market

Leaving aside constitutional driven assessments, the retroactive application of such measures would affect, as repeatedly mentioned, already consolidated transactions , and based on the assessments set forth above (*i.e.* recovery prospects, purchase price, value of individual receivables), would represent a significant risk for the relationships between the parties thereunder as well as for the market of non-performing loans, with even more complex effects when taking into account that loans may have been re-transferred by the assignee.

These effects, already particularly distorting in themselves, would be far worse if considered in the context of transactions involving the capital market. It is not infrequent, in fact, that ABS securities – issued in the context of securitisation transactions aimed at financing the purchase of receivables – are intended to be placed on the market (as, for example, also in GACS Transactions).

It is therefore clear that the regulations under discussion, applying to transactions that have already taken place, would completely overwhelm private agreements, in addition to obviously rendering the valuations carried out by investors completely out of date, and with potential impacts also on the ratings attributed to the ABS securities and on the business plans of such transactions.

In addition, the issue of coordinating the measures under discussion with the regulations on GACS transactions will be certainly critical. At present, in fact, about one-third of non-performing loans have been sold by banks as part of securitisation transactions assisted by the guarantee of the Republic of Italy, which may be required to repay any cash losses – if such losses have an impact on the senior tranche of ABS securities issued in the context of the transaction – and deriving specifically from the exercise of the Option and the consequent collec-

tion of an amount lower than the recoveries expected in the business plans.

Moreover, the business plan itself would undergo – due to the exercise of the Option – a downward adjustment of no small importance, diminishing the expected recovery prospects with an obvious impact on the senior tranche of the ABS securities, jeopardising the possibility of their repayment (with significant costs borne by the state, due to the trigger of the relevant guarantee), as well as the rating attributed to them. These fears would seem to be supported by the results of some simulations (so-called back testing) carried out on the GACS Transactions by market participants, assuming the entry into force of the considered provisions.

iv. Impact on servicing companies

As previously highlighted, in most cases, non-performing receivables are not managed directly by the assignee, but by specialized servicing companies (so-called servicers) which, in the name and on behalf of the assignee, pursuant to servicing agreements, outline - based on their experience - the guidelines, methods and objectives of recovery. All this, in practice, translates into a business plan drawn up, based on certain assumptions, by the servicing companies in order to identify, among other things, the expected value (so-called target) of recovery for each assigned receivable. The consistency of the recovery action put in place by the servicing companies through the business plan is of primary importance to these companies, also considering that the commercial agreements usually do not allow any amendment to the business plan. Indeed, on the basis of such a view, failure to comply with the same could lead to negative contractual and commercial consequences for servicers: first and foremost, the application of lower commission bases and - in case of serious deviations - the revocation of the mandate. It is clear that the retroactive nature of the considered measures makes it extremely complex for servicing companies to meet the contractual commitments and the proposed business plan, with possible negative effect on the business profitability and impact on employment.

v. Impact on debt behavior and on the "*Italian system*"

In conclusion, as also reiterated by the Bank of Italy, the negative repercussions that the "regularisation" brought by the Draft Law could have on the perception of the reliability and attractiveness of the 'Italian system' should not be ignored.

Firstly, because debtors, precisely in view of this "regularisation", could be induced to strategic defaults that would make it more convenient not to fulfil the debt contracted and to access, at a later date, the benefit of the Option.

Secondly, because an indiscriminate "regularisation" in favour of all defaulting debtors, without identifying reward criteria that include only debtors actually deserving of protection (*e.g.* because they are truly destitute), could discourage potential investors from taking action in the Italian non-performing loans market. Such progress, achieved also thanks to the huge investments made by national and international players on the capital market, could suffer a serious setback caused by the distorting impact that the rules under review, for the reasons repeatedly reiterated, would have on the emergence of new assignment transactions (a pivotal tool for de-risking operations).

At the same time, these measures, if also applicable to future assignments, could jeopardise the virtuous system of reducing the stock of non-performing loans and the consequent trend of improvement in regulatory ratios undertaken in recent years by Italian banks. This progress, achieved also thanks to investments made by national and international players in the capital market, could suffer a serious setback determined by the distorting impact that the rules in question, for the reasons repeatedly stated, would have on the emergence of new transactions de-risking operations.

Finally, the negative effect that the automatic cancellation from the so-called

Centrale Rischi would have on the credit-granting market, is not to be left out. This register, kept by the Bank of Italy, allows lenders to evaluate the possible borrowers of a loan more carefully, avoiding casual concessions to individuals with low creditworthiness. The cancellation envisaged by the Draft Law – which would originate from the simple Discharge Payment – would distort the purposes of the *Centrale Rischi*, not only because of the instantaneous timing with which it would intervene, but also because it would provide data that is not entirely truthful. In fact, a debtor cancelled because of a Discharge Payment would appear as a reliable debtor, even though such debtor has not fully discharged its debt.

vi. Contrasts with the NPLs Directive

The need to reform the non-performing receivables sector has led the European legislator to promulgate Directive (EU) 2021/2167 of the European Parliament and of the Council (the "**NPLs Directive**"), to be transposed by Member States by 29 December 2023, which, as highlighted in the relevant "recitals", has as its main objectives "*to enhance the development of secondary markets for NPLs in the Union while ensuring further strengthened protection of borrowers, in particular of consumers*". The regulations under consideration would not appear to be in line with what is provided for and envisaged by the NPLs Directive, since on one hand, for the reasons set out above, they do not contribute to the development of the secondary market for non-performing receivables, making it much more difficult and unstable, and on the other, they even seem to go beyond the debtor protection provisions of the NPLs Directive which, while providing for disclosure to assigned debtors, does not mention any obligation for a repurchase transaction (or option).

vii. Comparative experiences: the Greek example

The reformist intent animating the Italian legislator is not new on the European scene, as other regulatory experiences demonstrate. In this regard, for example, one can look with interest to the Greek market, not only for certain legislative similarities (think of the discipline of HAPS (state guarantee on securitised securities)) but also for the relevance of the non-performing receivables market in the country.

In particular, the Greek legislator has provided for the obligtion to submit - under certain conditions and only with reference to "consumer" debtors - a proposal to settle the debt through an appropriate transaction that, unlike the measures in the Draft Law, is not tied to an amount *a priori* decided by the legislator, but based on industry standard terms (*e.g.* specific portfolio credit policy, investors' instructions) and on the servicers' own operativity, which, through the servicing activities, aim to maximise recoveries based on the net book value of the receivables.

viii. Coordination of the measures under review with insolvency, judicial and extrajudicial proceedings

Article 4 of the Draft Law provides for transitional provisions and, in particular, measures of coordination with any judicial or extrajudicial proceedings, which have just been notified or are already pending at the date of entry into force of the rules in question. Basically, if the transferee, on the date of the entry into force of the Draft Law, has already served the debtor with a writ of summons or a first out-of-court document, the Option may be exercised within thirty days from the date of service. However, if such time limit has expired or the court or out-of-court proceedings are already pending, the fixed percentage making up the Discharge Payment shall increase to 40%.

On closer inspection, however, the provision would appear not to regulate the cases in which the debtor is subject to insolvency proceedings. If, in fact, the Option is exercised during such proceedings - assuming that this is permitted

under the current Draft Law - it could create situations of uncertainty and unequal treatment among the various creditors.

In light of such considerations, it is evident that the Draft Law, if approved, would lead to evident practical problems (in addition to relevant problems of legal coordination), with material impact on the Italian non-performing loans market.

Naturally, a reformist intervention in the non-performing receivables market could be desirable, but in a different way, and first and foremost by having a clear understanding of its characteristics as outlined in this paper. In particular, even in the context of the measures that will be adopted to transpose the NPLs Directive, considering different assumptions and prerequisites, intervention in favour of natural persons might be desirable, provided that such new measures (i) will relate to loans provided for the purchase of the first home within a certain limited amount, and (ii) will be applicable – as suggested by the Bank of Italy – to future transactions, avoiding to overwhelm transactions already completed with distorting effects on the underlying market.

In this context, it is suggested to note that, the so-called Budget Law 2020 (Law of December 27 December 2019, No. 160), already introduced - through the addition of paragraph 8-*bis* to Article 7.1 of Law 130 - the so-called "social value" securitization in order to smooth the way for the debtor to lease real estate subject to a mortgage guarantee on the related non-performing receivables. Such legislation, which as of today seems to have never been used, through appropriate amendments and additions could be the starting point for introducing an effective solution into the Italian legal landscape, with remedial and structural effects, to facilitate debtors who are natural persons in difficulty.

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