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Subject: Case SA.43390 (2016/N) - Italy - Italian securitisation scheme

Sir,

1. PROCEDURE

(1) In February 2015, the Italian authorities informally communicated to the European Commission (the "Commission") their intention to establish a system-wide Asset Management Company whose operations would not involve State aid, to address the problem of non-performing loans ("NPLs") on the balance sheets of Italian banks.

(2) From February to December 2015, the Italian authorities and the Commission services held several meetings and telephone conferences where the Italian authorities provided additional information. On 29 May 2015, the Italian authorities provided data on NPLs from the Central Credit Register ("CCR") of Bank of Italy. At the end of 2015, the Italian authorities informed the Commission services that they no longer wished to pursue a solution based on a centralised Asset Management Company but would consider other options.

(3) On 12 January 2016, the Italian authorities informed the Commission services about their intention to set up a guarantee scheme to support the securitisation of NPLs. A State guarantee would cover the senior tranches of securitisation structures containing NPLs from banks' balance sheets (the "Guarantee Scheme" or the "Scheme"). Further submissions and exchanges of information took place between 12 and 26 January 2016, including a meeting on 26 January 2016.

Onorevole Paolo Gentiloni
Ministro degli Affari esteri e della Cooperazione Internazionale
P.le della Farnesina 1
I - 00194 Roma

Commission européenne, B-1049 Bruxelles – Belgique
Europese Commissie, B-1049 Brussel – België
Telefono: 00-32-(0)2-299.11.11

(4) On 8 February 2016, the Italian authorities notified the measure for reasons of legal certainty.

(5) By letter dated 9 February 2016, Italy exceptionally agreed to waive its rights deriving from Article 342 of the Treaty on the Functioning of the European Union ("TFEU") in conjunction with Article 3 of Regulation 1/1958[1] and to have the present decision adopted and notified in English.

2. BACKGROUND

(6) The economic recession over recent years has severely affected the capacity of Italian firms and to a lesser extent of households to service their debt. It has led to a sharp increase of NPLs, up from EUR 87 billion in 2008 to EUR 337 billion[2] in June 2015. The NPL ratio[3] of the Italian banking sector as a whole has more than tripled since 2008 and stood at 17.5% at the end of June 2015. In November 2015 bad debts (*sofferenze*) – the worst category of impaired loans according to the classification used in Italy[4] – made up more than half of total NPLs and amounted to EUR 201 billion.

(7) The increase in the stock of NPLs has weakened the profitability and internal capital generation of Italian banks (in 2013, almost half of the banks' total operating income was absorbed by loan impairments[5]). Italian banks have increasingly allocated their resources to the management and work-out of NPLs, reducing their focus from new loan generation.

(8) The distressed debt market, which could allow banks to dispose of NPLs, is still underdeveloped in Italy, lagging behind those in other euro-area countries such as Spain or Ireland. Although recently there has been some evidence suggesting an increase in the volume of impaired asset sales in Italy, the number of transactions has remained very low and mainly involved the major banks in the Italian market.

(9) To contribute to reducing the overhang of NPLs, the Italian authorities intend to introduce the Guarantee Scheme, in parallel with a number of other reforms and measures aiming at improving the banks' ability to deal with NPLs (*inter alia* including the August 2015 reform of Italy's insolvency and foreclosure framework[6]).

3. DESCRIPTION OF THE NOTIFIED SCHEME

(10) Italy has notified a Guarantee Scheme where a State guarantee covers the senior tranches of securitisation structures containing NPLs from banks' balance sheets. Italy notified the Scheme for legal certainty and submits that the State guarantees

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1 OJ 17, 6.10.1958, p. 385.

2 Gross corporate and retail NPLs net of write-offs. Excludes foreign branches operating in Italy, includes Italian banks owned by foreign groups.

3 The NPL ratio is the ratio of the stock of non-performing loans and total credit to customers.

4 In Italy, impaired loans are classified into four categories: bad debts (*sofferenze*), substandard loans (*incagli*), restructured loans (*partite ristrutturate*) and overdue/overdrawn loans (*partite scadute*).

5 Commission Staff Working Document, Country Report Italy 2015 including an In-Depth Review on the prevention and correction of macroeconomic imbalances, 26.02.2015.

6 Law 132/2015 of 6 August 2015 (Decree Law 83/2015 of 27 June 2015).

granted under the Scheme do not constitute State aid as they are priced on market terms.

3.1. Securitisation structure

(11) The Guarantee Scheme is voluntary and open to all Italian banks. The Scheme's operation is based on individual banks seeking to set up a securitisation structure (the "originator"), with a State guarantee on the senior tranche as per the conditions described in Annex 1 and Annex 2 notified by the Italian authorities.

(12) The necessary financing is raised through issuing senior and junior notes. In addition, there is an option to issue mezzanine notes.

(13) The senior notes rank above the mezzanine and the junior notes in the waterfall structure and benefit from a State guarantee. The mezzanine notes rank between the senior and the junior notes. Neither the mezzanine nor the junior notes will benefit from a State guarantee.

(14) Both the senior and the mezzanine notes have a floating coupon and a flexible redemption structure to pass on cash flows from the securitised NPL portfolio. Coupons are paid quarterly, semi-annually or annually and are based on the remaining outstanding notional of the notes.

(15) The junior notes, which are initially underwritten by the issuer, rank the lowest and are fully participating in gains and losses. They do not give any right to cash flows until the notional of the senior and the mezzanine tranches have been repaid in full.

(16) The senior notes have an investment grade target rating of BBB-, Baa3, BBB-, BBBL or higher[7] taking into account the cost of the guarantee but not the protection of the State guarantee. The setup of the securitisation structure will be calibrated such that the target rating on the senior notes is achieved. The rating and the calibration is performed by an External Credit Assessment Institution (ECAI) approved by the ECB as of 1 January 2016 (the "rating agency")[8].

(17) Should two ratings be required under the applicable regulation, the second rating can be performed by a rating agency registered pursuant to Regulation 1060/2009. A guarantee under the Scheme can be provided only if both ratings are not lower than an Investment Grade rating. For the purpose of section 3.2, only the lower of the two ratings is considered.

(18) The State guarantee on the senior tranche will become effective only after the originating bank has sold to private investors at least 50% plus one share of the junior tranche at a positive value and has sold at a positive price a part of the junior and mezzanine tranches which is sufficiently large to achieve accounting de-recognition of the sold NPLs. The junior and the mezzanine notes cannot be bought by the State or by State-related bodies or companies.

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[7] BBB-, Baa3, BBB-, and BBBL are the corresponding ratings to the minimum investment grade rating in the rating scale of the four External Credit Assessment Institution (ECAI) approved by the ECB.

[8] Moody’s, Fitch, S&P and DBRS.

(19) NPLs on the originator's balance sheet are securitised at no higher than the current Net Book Value (NBV, gross book value minus current provisioning level).

(20) Upon securitisation, the originator will appoint an independent servicer to work-out the underlying NPLs of the securitisation structure. This will allow the rating agency, which will perform the calibration and assign a rating to the senior tranche of the securitisation structure (as described in recital (16)) to take into account the benefits that the work-out capabilities of the chosen servicer may bring. If the junior notes are sold after the originator has appointed a servicer of the NPLs, the new owner of the junior notes has the right to appoint a different servicer, subject to confirmation of a non-negative rating action by the rating agency.

(21) To manage potential liquidity mismatches between cash flows from the underlying NPL portfolio and contractually obligatory coupon payments on the senior and the mezzanine notes, the securitisation structure will seek a liquidity line (from either the originator or any other commercial bank) in an amount sufficient to achieve the minimum required rating. That liquidity line will rank senior to all notes in the waterfall structure.

(22) In accordance with the rating agency's criteria, possible interest rate mismatches between assets and liabilities of the securitisation structure will be covered with appropriate hedging arrangements to be negotiated between the issuer and suitable market counterparties.

(23) Cash flows from the underlying NPL portfolio and the swap counterparties will be used for payments in the following waterfall order:

(a) Obligatory regular payments

(i) Fees to the servicer;

(ii) Interest on the liquidity line;

(iii) Guarantee fees on the senior notes;

(iv) Payments to the swap counterparties;

(v) Interest on the senior notes;

(vi) Replenishment of the liquidity line (if previously utilized);

(b) Regular payments to mezzanine noteholders which may be subject to performance triggers and deferral provisions

(i) Interest on the mezzanine notes (if mezzanine notes present);

(c) Repayment starting at the highest seniority still outstanding

(i) Repayment in full of senior notes;

(ii) Repayment in full of mezzanine notes (if mezzanine notes present);

(iii) Pay-out on junior notes.

(24) Figure 1 shows a simplified graphical presentation of the securitisation structure:

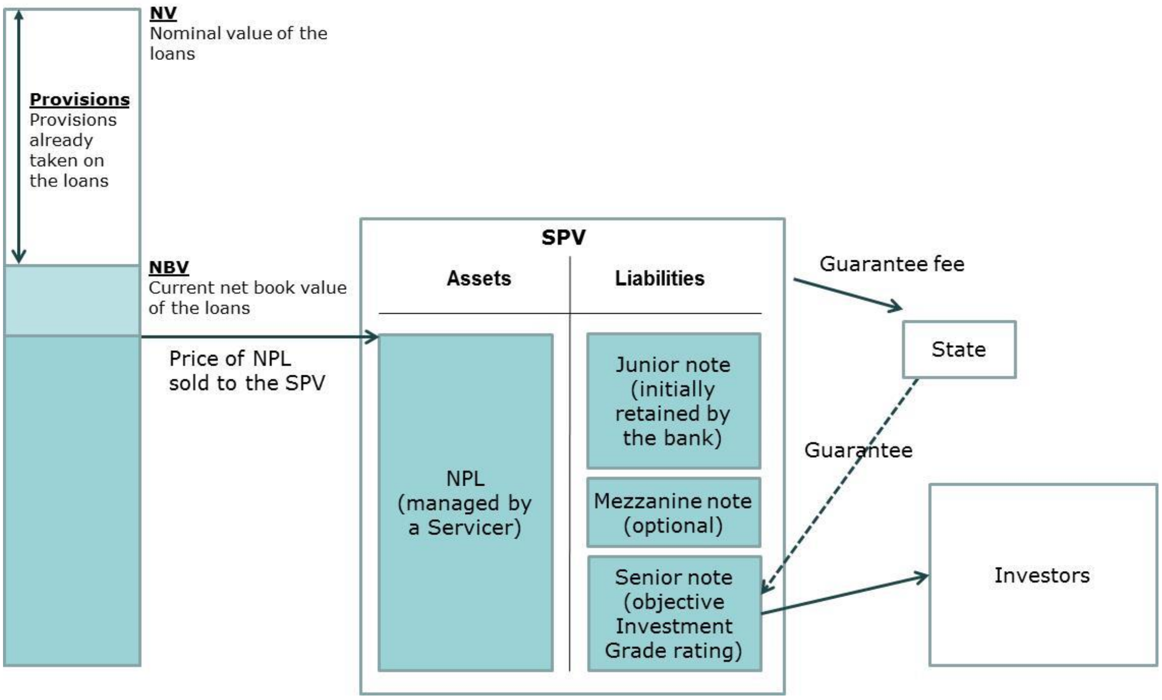

Figure 1 – Securitisation structure

3.2. Pricing of the State guarantee

(25) The pricing of the State guarantee on senior notes will be on market terms in order to ensure the aid-free nature of the Scheme. It will include remuneration in line with market conditions for the risks taken by the State and depending on the maturity of the notes. The market benchmark is given by the following:

(a) A basket of single name credit default swaps ("CDS") covering all Italian companies (financial and non-financial) which benefit from at least a rating from either S&P, Moody's or Fitch and with a rating equal to:

(i) BBB/Baa2, BBB-/Baa3 or BB+/Ba1 if the actual rating of the senior tranche is BBB-/Baa3/BBB-/BBB L;

(ii) BBB+/Baa1, BBB/Baa2, or BBB-/Baa3 if the actual rating of the senior tranche is BBB/Baa2/BBB/BBB;

(iii) BBB/Baa2, BBB+/Baa1 or A-/A3 if the actual rating of the senior tranche is BBB+/Baa1/BBB+/BBB H.

(b) The composition of the baskets will be fixed at the time of the approval of the Scheme for the duration of the Scheme. Italy has submitted the composition for each of the basket (see Annex 3). When the rating for a company in the basket changes so that it falls outside the ratings represented in the basket, it will leave the basket.

(c) For each CDS price as part of the benchmark basket, the average over the last six months of mid-prices at the time of the transaction is taken from the default database in Bloomberg for each single name CDS. Then a simple average over the resulting prices is taken to arrive at the CDS basket benchmark value.

(d) A basic step up fee is charged on the guarantee in the following way:

(i) in years 1, 2 and 3, the price of the 3y benchmark CDS is paid on the outstanding amount of the senior tranche;

(ii) in years 4 and 5, the price of the 5y benchmark CDS is paid on the outstanding amount of the senior tranche;

(iii) thereafter, the price of the 7y benchmark CDS is paid on the remaining outstanding amount of the senior tranche.

(e) An additional penalty (the "penalty") is applied in the following way:

(i) in years 4 and 5, if the senior tranche has not been repaid in full by the end of year 3, a penalty charge is added to the basic fee corresponding to making up the difference in payments from a 5y benchmark CDS held over the full period of years 1 to 5 compared to the actual payments made in years 1 to 3;

(ii) after year 5, if the senior tranche has not been repaid in full by the end of year 5, a penalty charge is added to the basic fee corresponding to making up the difference in payments from a 7y benchmark CDS held over the full period of years 1 to 7 compared to the actual payments made in years 1 to 5.

(f) The calculations in (d) are made on the basis of the following assumptions:

(i) a discount rate of 2%;

(ii) a linear repayment schedule of the senior tranche to be fully paid off after year 7[9].

3.3. Implementation

(26) Italy seeks legal certainty about the aid-free character of the Scheme, which will have a duration of 18 months as of the date of the present decision, implying an 18-month period during which the guarantees can be granted. Italy may decide to notify the prolongation of the Scheme. In such a case, all parameters are set to be reviewed after that period in order to ensure the continued aid-free character of the Scheme.

(27) Italy seeks a possibility to request a review by the Commission of the reference duration of the CDS component of the benchmark in the pricing methodology after six months of the implementation of the Scheme and, should the Member

[9] That assumption implies a yearly repayment rate of 1/7.

State avail itself of that possibility, to present empirical evidence showing the shortening workout times of the NPLs in Italy.

3.4. Commitments

(28) Italy hereby provides the following Commitments (the "Commitments") which present an integral part of the Guarantee Scheme as described under Annex 1 and Annex 2 notified by the Italian authorities.

(29) Italy commits to implement the Guarantee Scheme at the terms described in Annex 1 as notified by the Italian authorities.

(30) Italy commits that the rating and the calibration of the notes structure, i.e. the thickness of the different tranches of the securitisation notes, will take into account at least the following factors:

(a) The expected cash flows and their timings coming from the NPL servicing such as recovery payments, sales proceeds, etc.;

(b) Any cash flows received or paid under the hedging agreements;

(c) Fees for the servicing of NPLs;

(d) Contractual payment obligations on the issued notes;

(e) Guarantee fee on the guaranteed notes;

(f) Any other costs incurred by the securitisation structure in its normal business operations;

(g) The thickness of the junior tranche (and if present the mezzanine tranche).

(31) Italy commits to provide to the rating agency full access to at least the following information:

(a) Qualitative and quantitative information about the selected NPL servicer including:

(i) track record as successful private NPL servicer in Italy (aspects considered: successful, present in Italy, unproven/without track record, no specialist);

(ii) management team present on the specific deal;

(iii) fee structure.

(b) Loan-by-loan information on the underlying NPL portfolio including the full loan documentation and contractual documents, including the vintage of the NPL cohorts and related work-out times under judicial procedures;

(c) Access to anonymised information on work-out and recovery rates from the Italian central credit register in order to model work-out times under the judicial procedure and related recovery rates;

(d) The operational setup of the securitisation vehicle including all costs;

(e) The guarantee pricing formula to include related fee payments in the cash flow model.

(32) Where information is not available, assumptions will be made on a prudent basis.

(33) Italy commits that, if the Scheme covers not only *sofferenze* but also other categories of NPLs, the information reflecting specificities of those categories other than *sofferenze* will be made available to the rating agency.

(34) Italy commits to ensure that the Guarantee Scheme, its implementation and the various specificities in its setup, in particular the rating requirements and its application, will be subject to regular monitoring by a monitoring trustee, to be appointed by the Commission upon a proposal by Italy.

(35) Italy will make available to the monitoring trustee a report setting out how the different criteria and conditions set out in sections 3.1 and 3.2, and further in recitals (30) and (31) have been taken into account and contributed to the final rating result.

(36) Italy will ensure that both the originating banks and the rating agency will provide the necessary access to information for the monitoring trustee to enable it to discharge its monitoring duties.

(37) Italy commits that for each individual guarantee application under the Scheme, the pricing of the guarantee fee will be calculated based on the formula provided in Annex 4 applied at the time of the granting of the guarantee. The monitoring trustee will ensure that the changes in corporate ratings will be correctly reflected in the basket composition underlying the benchmark according to recital (25)(a) and Annex 1 as notified by the Italian authorities.

(38) Italy commits to limit the window for granting guarantees under the Scheme for a period of 18 months following the date of the present decision with an overall notional amount of guarantees estimated at EUR 5 billion.

(39) If a renewal of the Scheme is notified, Italy commits to provide a report on the usage of the Scheme together with the notification for renewal.

4. POSITION OF ITALY

(40) Italy has notified the Scheme for reasons of legal certainty and submits that any guarantee provided under the Scheme will be provided at market terms and therefore does not contain State aid within the meaning of Article 107(1) TFEU.

5. ASSESSMENT OF THE MEASURE

(41) Italy has notified the measure to the Commission as no aid for reasons of legal certainty. The Commission therefore has to assess whether the Scheme described in section 3 is free of State aid.

(42) By virtue of Article 107(1) TFEU *"any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market."*

(43) To constitute State aid within the meaning of Article 107(1) TFEU, a measure has to fulfil four conditions. First, the aid is granted by a Member State or through State resources. Second, the measure confers a selective advantage to certain undertakings or the production of certain goods. Third, the measure must be liable to affect trade between Member States. Fourth, the measure must distort or threaten to distort competition in the internal market.

(44) The Scheme will be implemented by governmental decree law. The law foresees a budget to be created. Individual guarantees will be granted under the Scheme by the Italian Minister of Economy and Finance. The Commission therefore concludes that the Scheme is imputable to the State and that it is financed through State resources.

(45) Given that the Scheme is designed to address banks with portfolios of NPLs, it is by its nature selective. In light of the characteristics of the financial services markets in the Union which feature high level of exchanges and trade, the Scheme is capable of affecting trade between Member States. If it were to provide an advantage to participating banks that they could not obtain on the market, the Scheme would be capable of distorting competition.

(46) In the following, the Commission will therefore assess whether the Scheme provides an advantage to participating banks through the special purpose vehicles (SPVs) they will be setting up.

5.1. Guarantee Notice

(47) In the Commission Notice on the application of Articles 87 and 88 of the EC Treaty to State aid in the form of guarantees[10] (the "Guarantee Notice"), the Commission has laid out conditions under which guarantee schemes can be considered not to include State aid.

(48) According to point 3.4 of the Guarantee Notice, regarding guarantee schemes, schemes can be considered free of State aid under the following conditions:

(a) The scheme is closed to borrowers in financial difficulties;

(b) The guarantee amount can be measured when it is granted;

(c) The guarantee cannot cover more than 80% of the outstanding financial obligation;

(d) The remuneration is based on a realistic assessment of the risk and the premiums paid so that the scheme can be considered self-financing;

(e) The level of premiums has to be reviewed at least every 12 months in view of the self-financing nature of the scheme;

(f) The premiums charged have to cover the normal risks associated with granting the guarantee, the administrative costs and a yearly remuneration on the necessary capital.

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10 OJ C 155, 20.6.2008, p. 10.

(49) According to the notification, some of the conditions in the above are clearly fulfilled such as (b) and (e). However, as there are no commitments to the contrary, the Commission cannot exclude that the Scheme is open to borrowers in financial difficulty or might be used in specific circumstances to provide guarantees covering more than 80% of the outstanding financial obligation. The Commission therefore considers it likely that these conditions will not be fulfilled in all instances of the Scheme's usage. Therefore the Commission cannot automatically exclude the presence of aid in the Scheme.

(50) Notwithstanding the above, according to point 3.1 of the Guarantee Notice, the assessment of the Commission regarding the existence of aid should in general be based "*on the principle of an investor operating in a market economy (the 'market economy investor principle', or 'MEIP'). […] State aid is not involved where a new funding source is made available on conditions which would be acceptable for a private operator under the normal conditions of a market economy*."

(51) The Commission will therefore assess the Scheme in light of that MEIP, bearing in mind that a guarantee provided under the Scheme can be free of State aid only if the State is remunerated at market terms for the risk it takes. Therefore, the Commission first assesses the risk taken by the State when providing such a guarantee and then whether that risk is remunerated under the proposed remuneration structure in a manner that it would be acceptable for a private operator under normal market conditions.

5.2. Risk taken by the State

(52) In the Impaired Asset Communication[11], the Commission has outlined the conditions for how a transfer of risks on impaired assets from a bank concerned to the State can be structured either (a) at market value without State aid or (b) at the real economic value with compatible State aid.

(53) In the notified Scheme, the Commission will not be in a position to perform a case-by-case assessment of the value of the underlying assets. However, given the specific construction of the Scheme, the risk to which the State will be exposed can be assessed independently of the assessment of the value of the underlying assets. This risk is limited to an investment grade senior tranche in all cases where a guarantee is granted as per the construction of the Scheme as assessed in recitals (54) to (58). Consequently, the remuneration that a private operator would ask for insuring such risk can also be assessed.

(54) First, the Commission notes that the NPLs' management is transferred to an independent servicer, a company specialised in NPL management whose management fee has a usually high performance-related component. Engaging such an independent servicer will increase the likely recovery and reduce the risk of the work-out not being performed in the most efficient way available.

(55) Second, the Commission notes that the senior tranche has a fully preferred status. Cash flows cannot be paid to the junior (recital (15)) and mezzanine tranches (recital (23)(c)(i)) before the senior tranche has been repaid in full.

[11] Communication from the Commission on the treatment of impaired assets in the Community banking sector, OJ C 72, 26.03.2009, p. 1.

(56) Third, the Commission notes that the exposure of the State is confined to the senior tranche of the securitisation vehicle. The proportion of un-guaranteed and loss-absorbing junior and mezzanine tranches (the latter being optional) in comparison with the overall financing of the SPVs will be such that the senior tranche receives an investment grade rating (BBB- or higher) before taking into account the State guarantee.

(57) Fourth, the pre-guarantee rating of the senior tranche and the size of the loss-absorbing tranches will be established taking into account the points set out in recitals (54) to (56) by an ECAI approved by the ECB, ensuring that the necessary expertise for providing such a rating is available.

(58) Finally, the Commission takes account of the fact that the guarantee will only be effective once the originating bank has sold first 50% plus one share of the junior tranches to a private market participant at a positive price. Given that the SPV's assets only consist of the NPLs portfolio and that its liabilities consist of senior and loss-absorbing tranches, achieving a market sale of the junior tranche at positive price implies that the market considers that the value of the NPL portfolio exceeds the value of the senior tranche. Therefore, any State guarantee on the senior tranche provided under the Scheme will in effect guarantee less than the market value of the underlying assets.

(59) The Commission considers that the elements in recitals (54) to (58) clearly define the exposure of the State and provide a significant amount of confidence that the State guarantee is not provided at a level where losses are likely[12]. That confidence is increased further by Italy's commitments to:

(a) Provide the rating agency with all the necessary information (recital (31)) to do a prudent assessment, in particular the information about the historical state and current development of the work-out speed in the Italian NPL market;

(b) Ensure that the data provided is taken into account in the process of providing the rating for the senior tranche;

(c) Submit the Scheme and the actions of the rating agencies involved to independent monitoring by a monitoring trustee.

(60) The Commission therefore concludes that the exposure of the State through the State guarantee on the senior tranche in the Scheme as notified will be limited to that of an investment grade instrument, based on expert determination and verified by market-based elements. Using only an ECAI for the expert determination, taken together with Italy's commitments to provide the necessary information and ensure that it is used, in conjunction with the submission of the Scheme to Commission monitoring provides the Commission with additional comfort that consistency across individual applications for guarantees under the Scheme is preserved.

[12] If this was the case, it would directly contradict the fact that the senior tranche had received an investment grade rating.

5.3. Remuneration

(61) Given the clear limits on the exposure taken by the State, the Commission takes the view that remuneration for the guarantee at market terms would ensure that the State is acting according to the MEIP. In that case, the State guarantee would not give rise to any selective advantage for the participating banks and SPVs.

(62) With respect to the proposed pricing methodology, the Commission observes that the type of instrument envisaged by Italy is not currently traded in the Italian market. Therefore, no direct comparison with observable market transaction for the same financial instrument can be made. However, the Commission considers that it is possible to find market benchmarks which would indicate the adequate level of remuneration for equivalent levels of risk incurred as reflected by the investment grade rating of the senior tranche, and the duration of the exposure of the State.

(63) The pricing formula proposed by Italy consists of three separate elements:

(a) The construction of an appropriate benchmark index for market prices (the "benchmark");

(b) The choice of an appropriate remuneration rate based on the benchmark (the "base rate");

(c) The choice of an appropriate penalty premium to be applied where required (the penalty referred to in recital (25)(e)).

(64) The Commission will consider these three elements in turn.

5.3.1. The benchmark

(65) The benchmark is constructed as a basket containing multiple securities. All securities are CDS on Italian companies. The precise company names are chosen such that for a specific rating of the senior tranche – which can be either BBB-, BBB or BBB+ – they benefit themselves from ratings corresponding to the target rating +/- one notch[13]. If a company is rated by multiple ECAIs, the average rating is considered.

(66) The Commission considers that due to the underlying companies' sizes and investment grade ratings, the market for the single name CDS which enter the benchmark is sufficiently liquid so that they represent reliable market price indicators.

(67) The baskets for the three possible ratings for the senior tranche are fixed as per the present decision and are provided in the Annex 3. The Commission considers that the construction is appropriate as a market benchmark as it reflects the geographic risk and retains significant exposure to the financial sector where the underlying NPL exposures derive from while also reflecting the fact that the actual risk taken corresponds to the wider Italian market. Using a simple average

[13] One notch corresponds to the smallest increment on the rating scale. Correspondingly, the difference between BBB and BBB+ is one notch and the securities deemed appropriate as reference points for a senior tranche with BBB rating benefit from ratings of BBB-, BBB or BBB+.

over all values in the basket also reduces sufficiently the idiosyncratic risk towards each single company in the basket.

(68) Further, the Commission takes positive note of the fact that for each CDS, instead of the current spot mid-price, the average over the previous six months of close mid-prices is used for the purpose of calculating the value of the benchmark basket. That feature will reduce volatility in the Scheme also over time.

5.3.2. The base rate and penalty

(69) The choice of the base rate and penalty in the Scheme is driven by the fact that the actual market price of such a guarantee will depend not only on the level of risk implied by an investment grade rating and priced based on the CDS benchmark, but also on how long the State will retain its exposure to the risk that it guarantees. That last element, in turn, depends on how long it will take to repay the senior tranche in full and thereby terminate the guarantee.

(70) In the Scheme, the step-up takes the form of the base rate in years 1 to 3 being linked to the *ex-ante* three-year tenor of the benchmark, in years 4 and 5 being linked to the *ex-ante* five-year tenor of the benchmark and from year 6 onwards to the *ex-ante* seven-year tenor of the benchmark. To that is added a penalty in years 4 to 7. The resulting rate (base rate + penalty) is then applied to the actually outstanding amount of the senior tranche.

Based on the work-out counterfactual and a discount rate of 2%, the penalty in years 4 and 5 is calibrated such that the discounted cash value paid by year 5 under the Scheme corresponds to the hypothetical value if the five-year tenor of the benchmark had been paid over all years 1 to 5. Equally, the penalty in years 6 and 7 is calibrated such that the discounted cash value paid by year 7 under the Scheme corresponds to the hypothetical value if the seven-year tenor of the benchmark had been paid over all years 1 to 7. *Figure* below shows an example of the step-up compensation mechanism.

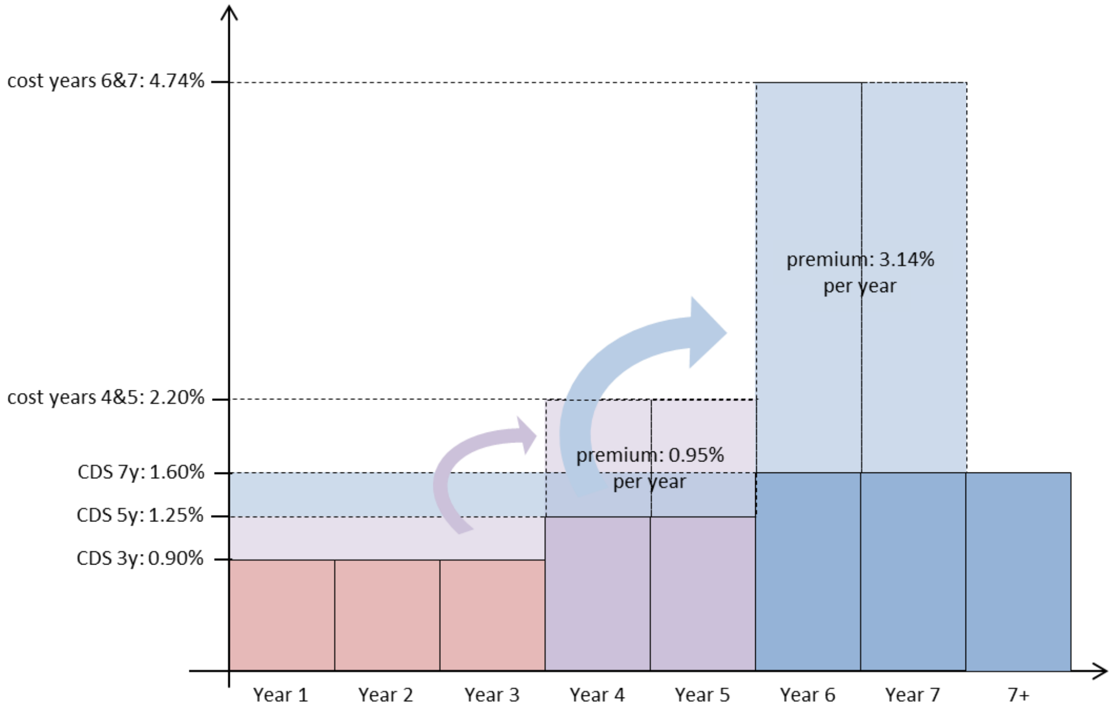


Figure 2 - Step-up compensation structure, example

(71) Assuming both the work-out counterfactual and a discount rate of 2%, it is possible to calculate the penalty rates for years 4 to 7 as a function of the appropriate base rates. In years 4 and 5, the penalty will be 2.7 times the difference between the five-year and the three-year tenor of the benchmark. In years 6 and 7, the penalty will be 8.98 times the difference between the seven-year and the five-year tenor of the benchmark. A derivation of those factors is provided in Annex 4.

(72) The Commission notes at this point that according to its own analysis the sensitivity of the penalty to the discount rate is small. However, a discount rate of 2% is significantly greater than the current seven-year yield on Italian government bonds[14] and can therefore be considered conservative.

(73) Based on the available data, including the data from the CCR, the Commission considers that it is unlikely that substantial proportions of a senior tranche benefitting from a guarantee under the Scheme will remain outstanding beyond the seven year point. The Commission also recalls that the combination of the following three elements further decreases such a likelihood:

(a) By construction of the Scheme, cash flows on the junior tranche can be paid only after the full repayment of the senior tranche.

(b) A guarantee under the Scheme will only be provided if the majority of the junior tranche can be successfully sold to a private market investor.

(c) Investors present in the market as potential buyers for the junior (and, if present, the mezzanine) tranche will have high return expectations as well as a strong preference for cash flows in the short to medium term.

(74) Therefore, the Commission considers that the seven year tenor corresponds to a time when a significant reduction in risk taken by the State will have been achieved even if the senior tranche has not yet been repaid in full.

(75) The Commission highlights that the construction of the step-up mechanism puts significant emphasis on achieving the work-out targets implicit in the counterfactual work-out profile for years 4 and 5 and even more for years 6 and 7. If those targets cannot be achieved, remuneration to the State will significantly increase compared to the counterfactual work-out through the high penalty rates applicable in years 4 to 7.

(76) In that respect, the Commission also notes positively that the incentive structure created by the step-up fully aligns the interests of the servicer – who is usually remunerated depending on the success of its operations – with those of the economic owners, the holders of the junior tranche. That feature will again favour the fastest possible work-out while operating in the fashion which best preserves value.

(77) Based on the preceding considerations, the Commission comes to the conclusion that in the context of the proposed structure of the Scheme, the step-up

[14] The yield of Italian 7-year government bonds as of 5 February 2016 stood below 1% and has not been above 2% since 2014.

mechanism ensures that the remuneration of the guarantee to the State corresponds to the level and duration of the risk the State takes. If actual work-out times are shorter than in the work-out counterfactual, the step-up mechanism will result in lower compensation paid for the guarantee, commensurate with the shorter duration of the exposure of the State. If the work-out times are long, the State gets paid more, in line with what a market economy operator would require.

(78) While the preceding assessment of remuneration is based on the currently available data, the Commission acknowledges the efforts made by Italy to speed up the work-out of NPLs by enacting legal reforms to that effect. Therefore, the Commission agrees to include the possibility to review the reference duration of the CDS component of the benchmark in the pricing methodology. Such a review would be launched at the request of Italy six months after the implementation of the Scheme. Should Italy present such a request, the Commission will assess it to determine whether the empirical evidence and the market conditions justify the revision of the pricing methodology on this particular point.

5.4. Conclusion

(79) Taking risk and remuneration together, the Commission concludes that the pricing structure provided is in line with market conditions. The risk taken by the State is remunerated at a level which a market operator would require, including a strong link between the risk taken and the composition of the benchmark basket as well as between the time during which that risk is retained and the remuneration paid.

(80) The Commission concludes that the State guarantee provided to the securitisation structure as described in the present decision in section 3, Annex 1 and Annex 2, and remunerated in line with the remuneration structure as described in section 3.2 and Annex 4, is provided at market terms and therefore does not confer an advantage to the participating banks and SPVs.

6. CONCLUSION

The Commission has decided not to raise objections to the measure notified by Italy, in light of the commitments made by that Member State (including those relating to the activities and remuneration of a monitoring trustee). On that basis, the Commission has decided that the measure does not constitute aid within the meaning of Article 107 (1) TFEU.

If this letter contains confidential information which should not be disclosed to third parties, please inform the Commission within fifteen working days of the date of receipt. If the Commission does not receive a reasoned request by that deadline, you will be deemed to agree to the disclosure to third parties and to the publication of the full text of the letter in the authentic language on the Internet site: http://ec.europa.eu/competition/elojade/isef/index.cfm.

Your request should be sent electronically to the following address:

European Commission,
Directorate-General Competition
State Aid Greffe
B-1049 Brussels
Stateaidgreffe@ec.europa.eu

Yours faithfully,
For the Commission

Margrethe VESTAGER
Member of the Commission

CERTIFIED COPY
For the Secretary-General,

Jordi AYET PUIGARNAU
Director of the Registry
EUROPEAN COMMISSION

Annex 1 – Description of the Scheme

Italy is considering putting in place a guarantee scheme where a State guarantee covers the senior tranches of securitisation structures containing NPLs from banks' balance sheets (the "Guarantee Scheme" or the "Scheme"). Italy wishes to set up the Scheme as no-aid. Therefore, the pricing of State guarantees has to be at market terms in order to avoid the presence of State aid.

1. Description of the securitisation structure

(1) The Guarantee Scheme is voluntary and open to all banks. The Scheme's operation is based on individual banks seeking to set up a securitisation structure as described in the conditions of the Scheme, and asking for a State guarantee on the senior tranche as per conditions described in section 3.

(2) The State guarantee on the senior tranche will become effective only after the originating bank has sold to private investors at least 50% plus 1 shares of the junior tranches at a positive value and has sold a sufficiently large part of the junior and mezzanine tranches at positive prices to achieve accounting de-recognition of the sold NPL. Neither mezzanine nor junior notes will benefit from a State guarantee. No State, State-related body or company can buy junior or mezzanine notes.

(3) NPLs on the originator's balance sheet are securitised at no higher than the current Net Book Value (NBV, gross book value minus current provisioning level).

(4) Upon securitisation, the originator will appoint an independent NPL servicer for the securitisation structure in order to allow the rating agency to take into account its better work-out abilities. If junior notes are sold immediately, the new owner of the junior notes has the right to appoint a different servicer of the NPLs subject to confirmation of non-negative rating action by the Rating Agencies.

(5) The necessary financing is raised through issuing senior and junior or senior, mezzanine and junior of notes.

(6) Senior notes rank above mezzanine in the waterfall structure and benefit from a State guarantee. Mezzanine notes rank between senior and junior. The originator will sell

to private investors an amount of junior and mezzanine notes sufficient to achieve accounting derecognition of the securitized non-performing loans. Neither mezzanine nor junior notes will benefit from a State guarantee. No State, State-related body or company can buy mezzanine notes.

(7) Both senior and mezzanine notes have a floating coupon and flexible redemption structure to pass on cash flows from the securitised NPL portfolio. Coupons are paid quarterly, semi-annually or annually based on the remaining outstanding notional of the notes. Appropriate hedging arrangements will be negotiated between the issuer and suitable market counterparties - in accordance with Rating Agency criteria - to cover any interest rate mismatch between assets and liabilities.

(8) Junior notes rank lowest, are fully participating in gains and losses, do not benefit from a State guarantee and are initially underwritten by the issuer. They do not give right to cash flows until the notional of senior and mezzanine tranches are repaid in full. They will be sold to private investors at least in an amount sufficient for the originator to achieve accounting derecognition of the securitized non-performing loans. No State, State-related body or company can buy the junior notes.

(9) To manage potential liquidity mismatches between cash flows from the underlying NPL portfolio and contractually obligatory coupon payments, the securitisation structure will seek a liquidity line (from either originator or any other commercial bank) in amount sufficient to achieve the minimum required rating. This liquidity line will be serviced senior to all notes.

(10) Correspondingly, cash flows from the underlying NPL portfolio and the swap counterparties will be used for payments in the following waterfall order:

Obligatory regular payments

a. Fees to the servicer
b. Interest on the liquidity line
c. Guarantee fees on the senior notes
d. Payments to the swap counterparties
e. Interest on the senior notes
f. Replenishment of the liquidity line (if previously utilized).

Regular payments to mezzanine noteholders which may be subject to performance triggers and deferral provisions.

g. Interest on the mezzanine notes (if mezzanine notes present)

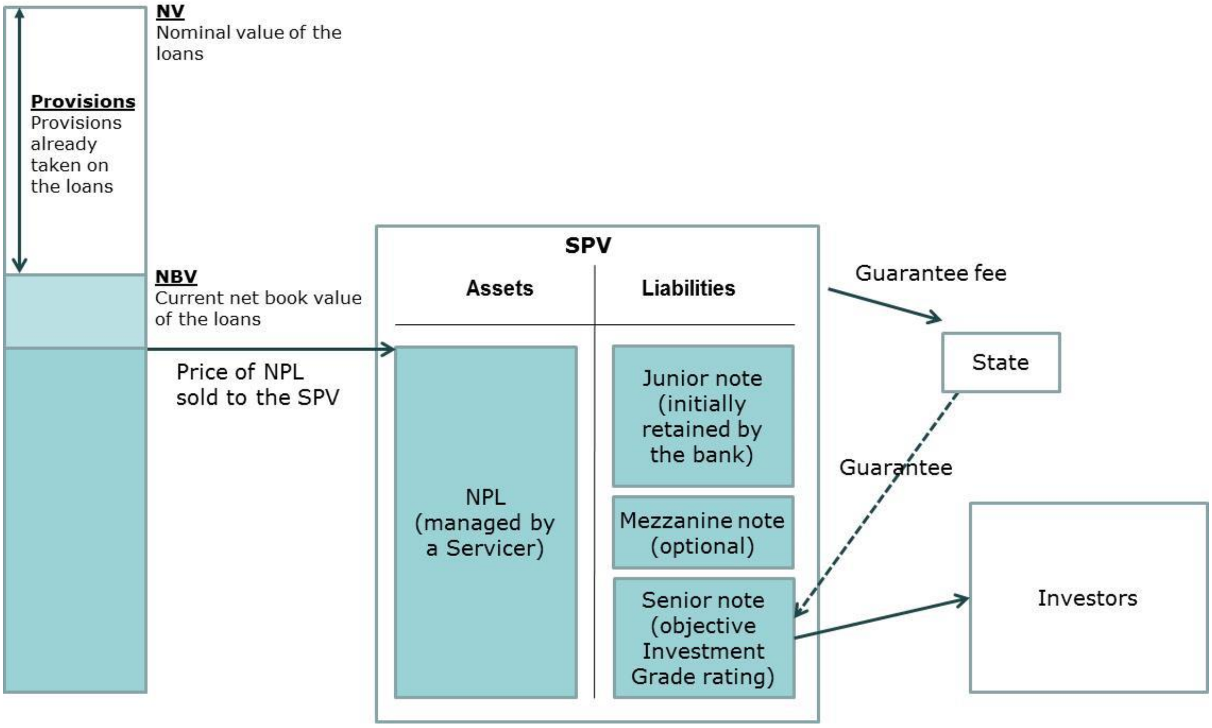
Repayment starting at the highest seniority still outstanding

h. Repayment in full of senior notes

i. Repayment in full of mezzanine notes (if mezzanine notes present)

j. Payout on junior notes

The following makes a simplified graphical presentation of the securitisation structure:



2. Rating

(11) The senior notes have an Investment Grade target rating of (BBB-, Baa3, BBB-, BBBL or higher) not taking into account the protection of the State guarantee, but taking into account the cost of the guarantee. The setup of the securitisation structure will be calibrated such that this target rating on the senior notes is achieved. The rating and this calibration is performed by an External Credit Assessment Institution

(ECAI) approved by the ECB as of 1 January 2016[15]. Should two ratings be required under the applicable regulation, the second rating can be performed by a rating agency registered pursuant Regulation 1060/2009. A guarantee under the Scheme can be provided only if both ratings are not lower than an Investment Grade rating. For the purpose of Section 3, only the lower of the two ratings is considered.

3. Pricing of the State guarantee on senior notes

(12) The pricing of the State guarantee on senior notes will be on market terms in order to ensure the aid-free nature of the Scheme. It will include market-conform remuneration for the risks taken by the State and depending on the maturity of the notes. The market benchmark is given by the following:

a. A basket of single name CDS covering all Italian companies (financial and non-financial) which benefit of at least a rating of either S&P, Moody's or Fitch and with a rating equal to:

   i. BBB/Baa2, BBB-/Baa3 or BB+/Ba1 if the actual rating of the senior tranche is BBB-/Baa3/BBB-/BBB L;

   ii. BBB+/Baa1, BBB/Baa2, or BBB-/Baa3 if the actual rating of the senior tranche is BBB/Baa2/BBB/BBB;

   iii. BBB/Baa2, BBB+/Baa1 or A-/A3 if the actual rating of the senior tranche is BBB+/Baa1/BBB+/BBB H.

   The baskets composition will be fixed at the time of the approval of the Scheme for the duration of the Scheme; when the rating for a company in the basket changes so that it falls outside the ratings represented in the basket, it will leave the basket.

b. For each CDS price as part of the benchmark basket, the average over the last 6-month of mid-prices at the time of the transaction is taken from the default database in Bloomberg for each single name CDS. Then a simple average over the resulting prices is taken to arrive at the CDS basket benchmark value.

c. A basic step up fee is charged on the guarantee in the following way:

   i. in years 1, 2 and 3, the price of the 3y benchmark CDS is paid on the outstanding amount of the senior tranche;

[15] Moody’s, Fitch, S&P and DBRS

ii. in years 4 and 5, the price of the 5y benchmark CDS is paid on the outstanding amount of the senior tranche;

iii. thereafter, the price of the 7y benchmark CDS is paid on the remaining outstanding amount of the senior tranche.

d. An additional penalty is applied in the following way:

i. in years 4 and 5, if the senior tranche has not been repaid in full by the end of year 3, a penalty charge is added to the basic fee corresponding to making up the difference in payments from a 5y benchmark CDS held over the full period of years 1 to 5 compared to the actual payments made in years 1 to 3;

ii. in years 6 and 7, if the senior tranche has not been repaid in full by the end of year 5, a penalty charge is added to the basic fee corresponding to making up the difference in payments from a 7y benchmark CDS held over the full period of years 1 to 7 compared to the actual payments made in years 1 to 5.

e. The calculations in d. are made on the basis of the following assumptions:

i. a discount rate of 2%

ii. a linear repayment schedule of the senior tranche to be fully paid off after year 7[16].

4. Approval and Implementation

(13) The approval of the Scheme as no-aid guarantee scheme via a Commission decision will be given for 18 months, implying an 18-month period during which the guarantees can be granted, renewable upon notification. All parameters are set to be reviewed after that period in order to be able to ensure the continued aid-free character of the scheme.

(14) Italy can request a review of the reference duration of the CDS component of the benchmark in the pricing methodology after 6 months of the implementation of the Scheme and present the empirical evidence showing the shortening workout times of the NPLs in Italy. The Commission will assess such request in order to determine

[16] This assumption implies a yearly repayment rate of 1/7.

whether the empirical evidence and the market conditions justify the revision of the pricing methodology on this particular point.

Annex 2 – Italy commitments

Italy hereby provides the following Commitments (the "Commitments") which are integral part of the Guarantee Scheme as described under Annex 1 - "Description of the measure".

(1) Italy commits to implement the Guarantee Scheme at the terms described under Annex 1.

(2) Italy commits that the rating and the calibration of the notes structure, i.e. the thickness of the different tranches of the securitisation notes, will take into account at least the following factors:

a. The expected cash flows and their timings coming from the NPL servicing such as recovery payments, sales proceeds, etc.;

b. Any cashflows received or paid under the hedging agreements;

c. Fees for the servicing of NPLs;

d. Contractual payment obligations on the issued notes;

e. Guarantee fee on the guaranteed notes;

f. Any other costs incurred by the securitisation structure in its normal business operations;

g. The thickness of the junior tranche (and if present the mezzanine tranche).

(3) Italy commits to provide to the rating agency full access to at least the following information:

a. Qualitative and quantitative information about the selected NPL servicer including:

i. track record as successful private NPL servicer in Italy (aspects considered: successful, present in Italy, unproven/without track record, no specialist);

ii. management team present on the specific deal;

iii. fee structure.

b. Loan-by-loan information on the underlying NPL portfolio including the full loan documentation and contractual documents, including the vintage of the NPL cohorts and related work-out times under judicial procedures;

c. Access to anonymised information on work-out and recovery rates from the Italian central credit register in order to model work-out times under the judicial procedure and related recovery rates;

d. The operational setup of the securitisation vehicle including all costs;

e. The guarantee pricing formula to include related fee payments in the cash flow model.

(4) Where information is not available, assumptions will be made on a prudent basis.

(5) Italy commits that, if the scheme covers not only sofferenze but also other categories of NPLs, the information reflecting specificities of those categories other than sofferenze will be made available to the rating agency.

(6) Italy commits to ensure that the Guarantee Scheme, its implementation and the various specificities in its setup, in particular the rating requirements and its application, will be subject to regular monitoring by a monitoring trustee, to be appointed by the Commission upon proposal by Italy.

(7) Italy will make available to the monitoring trustee a report setting out how the different criteria and conditions set out above have been taken into account and contributed to the final rating result.

(8) Italy will ensure that both the originating banks and the rating agency will provide the necessary access to information for the monitoring trustee to enable it to discharge its monitoring duties.

(9) Italy commits that for each individual guarantee application under the Scheme, the pricing of the guarantee fee will be calculated based on the formula provided in Annex 1 applied at the time of the granting of the guarantee. The monitoring trustee will ensure that the changes in corporate ratings will be correctly reflected in the basket composition underlying the benchmark according to Recital (12) in Annex 1.

(10) Italy commits to limit the window for granting guarantees under the Scheme for a period of 18 months following the Commission approval of the Guarantee Scheme as a no-aid guarantee scheme.

(11) If a renewal of the scheme is notified, Italy commits to provide a report on the usage of the scheme together with the notification for renewal.

Annex 3 – Baskets

1) First Basket
(used if the rating of the senior tranche is BBB-/Baa3/BBB-/BBB L)

UBI BANCA SPA
UNICREDIT SPA
INTESA SANPAOLO
ENEL SPA
ACEA SPA
TELECOM ITALIA SPA
FINMECCANICA SPA
MEDIOBANCA SPA

2) Second Basket
(used if the rating of the senior tranche is BBB/Baa2/BBB/BBB)

UBI BANCA SPA
MEDIOBANCA SPA
UNICREDIT SPA
INTESA SANPAOLO SPA
ASSICURAZIONI GENERALI SPA
ENEL SPA
ACEA SPA
ATLANTIA SPA

3) Third Basket
(used if the rating of the senior tranche is BBB+/Baa1/BBB+/BBB H)

UBI BANCA SPA
UNICREDIT SPA
INTESA SANPAOLO SPA
ASSICURAZIONI GENERALI SPA
ENEL SPA
ACEA SPA
ENI SPA
ATLANTIA SPA

Annex 4 – Guarantee pricing formula

(1) In years 1, 2 and 3, the benchmark 3y CDS rate is paid. In years 4 and 5, the benchmark 5y CDS rate plus a premium $\mathrm{P}_{3-5\mathrm{y}}$ is paid. In years 6 and 7, the benchmark 7y CDS rate plus a premium $\mathrm{P}_{5-7\mathrm{y}}$ is paid. The benchmark 7y CDS rate is paid thereafter.

(2) The premiums $\mathrm{P}_{3-5\mathrm{y}}$ and $\mathrm{P}_{5-7\mathrm{y}}$ are calculated based on the following two assumptions:

a. The outstanding amount of the guaranteed senior tranche is decreasing linearly to 0 over a period of seven years.

b. The applicable discount rate is 2%.

(3) Based on these assumptions, the premium $\mathrm{P}_{3-5\mathrm{y}}$ is then calculated such that the discounted cash value paid by year 5 under the scheme corresponds to the hypothetical value if the benchmark 5y CDS rate had been paid over all years 1 to 5. Correspondingly, the premium $\mathrm{P}_{5-7\mathrm{y}}$ is calculated such that the discounted cash value paid by year 7 under the scheme corresponds to the hypothetical value if the benchmark 7y CDS rate had been paid over all years 1 to 7.

(4) Then, the applicable premiums are given by

a. For years 4 and 5:

P_{3-5y} = 2.70 times (5y CDS rate – 3y CDS rate)

b. For years 6 and 7:

P_{5-7y} = 8.98 times (7y CDS rate – 5y CDS rate)

(5) The factors 2.70 and 8.98 in the two formulas above are constant and fixed for the duration of the scheme but depend on the two assumptions in point (2). A detailed derivation is given below.

(6) The cash amounts to be paid at the end of each interest payment period are calculated based on the applicable rate in a given year as defined in point (1) applied to the actually outstanding amount of the senior tranche at the beginning of the interest payment period.

<u>Derivation</u>

(7) According to point (3) above, the following equation can be written:

$$\sum_{i=1}^{5} CDS_{5y} * F(t_{i-1}) * DF(t_i) = \sum_{i=1}^{3} CDS_{3y} * F(t_{i-1}) * DF(t_i) + \sum_{i=4}^{5} (CDS_{5y} + P_{3-5y}) * F(t_{i-1}) * DF(t_i)$$

Where CDS_{3y} and CDS_{5y} correspond to the benchmark 3y and 5y CDS spreads, $F(t_i)$ corresponds to the workout function, standing for the outstanding amount of the senior tranche at time t_i, $DF(t_i)$ being the applicable discount factor at time t_i, and P_{3-5y} being the appropriate premium to apply in years 4 and 5.

(8) This equation can be solved easily for the premium value P_{3-5y}:

$$P_{3-5y} = \left(CDS_{5y} - CDS_{3y}\right) * {\sum_{i=1}^{3} F(t_{i-1}) * DF(t_i)} \Big/ {\sum_{i=4}^{5} F(t_{i-1}) * DF(t_i)}$$

(9) The same calculation can be made for the applicable premium in years 6 and 7:

$$\sum_{i=1}^{7} CDS_{7y} * F(t_{i-1}) * DF(t_i) = \sum_{i=1}^{5} CDS_{5y} * F(t_{i-1}) * DF(t_i) + \sum_{i=6}^{7} (CDS_{7y} + P_{5-7y}) * F(t_{i-1}) * DF(t_i)$$

$$P_{5-7y} = \left(CDS_{7y} - CDS_{5y}\right) * {\sum_{i=1}^{5} F(t_{i-1}) * DF(t_i)} \Big/ {\sum_{i=6}^{7} F(t_{i-1}) * DF(t_i)}$$

(10) Under the assumptions in point (2), the functional forms for $F(t_i)$ and $DF(t_i)$ are given by

$$F(t_i) = {7 - t_i}/{7} \ (linear\ decrease\ over\ 7\ years)$$

$DF(t_i) = {1}/{(1+r)^{t_i}}$ (*discount factor with discount rate r*)

(11) Substituting these functional forms into the equations in point (8) and (9) and according to the assumptions (2) taking a 2% discount rate, it is then possible to calculate values for P_{3-5y} and P_{5-7y}:

$$P_{3-5y} = {(7(1+r)^4 + 6(1+r)^3 + 5(1+r)^2)}\Big/{(7+4r)} * \left(CDS_{5y} - CDS_{3y}\right)$$

$$= 2.70 * \left(CDS_{5y} - CDS_{3y}\right)$$

$$P_{3-5y} = {(7(1+r)^6 + 6(1+r)^5 + 5(1+r)^4 + 4(1+r)^3 + 3(1+r)^2)}\Big/{(3+2r)}$$

$$* \left(CDS_{7y} - CDS_{5y}\right) = 8.98 * \left(CDS_{7y} - CDS_{5y}\right)$$