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COMMENTARY

Italian Lending Market Finally Opens to Nonbanking Lenders

Concluding a process started during the summer of 2014, the Italian legislature has completed a set of measures governing direct lending by nonbanking institutions. As a result, Italian/European Union ("EU") insurance companies, alternative investment funds, and securitization vehicles may now lend into Italy. Qualified lenders may lend into Italy based on the new measures introduced by Law Decree no. 91 of June 24, 2014 ("Law Decree"), as converted into law by the Italian Parliament on August 7, 2014 with only limited changes, and by Law Decree level 2 and 3 implementing measures.

This *Commentary* summarizes the general terms pursuant to which nonbanking qualified lenders may carry out direct lending into Italy.

Lending in Italy

Insurance companies, alternative investment funds, and securitization vehicles may carry out direct lending into Italy and also take advantage of the tax measures introduced to support direct lending into Italy by qualified lenders.

Lending License. As a rule, lending in Italy on a professional basis vis-à-vis the public is reserved to licensed banks and financial institutions.

Italian Insurance Companies. Italian insurance companies may lend to Italian businesses,[1] provided that they are previously licensed by IVASS (the Italian public authority supervising insurance companies) and to the extent that:

- The borrower is identified by a licensed bank or a financial intermediary;
- The licensed bank or the financial intermediary identifying the borrower retains a "significant interest" in the financing transactions for the entire life of the loan (so-called "net retention");
- The borrower has an adequate internal control and risk management system; and
- The borrower is adequately capitalized.

IVASS recently issued the Law Decree implementing measures, which strengthened the net retention threshold from 5 percent to 50 percent of the total loan amount and pointed out certain risk-spreading criteria that vary depending on each borrower's qualities (e.g., creditworthiness, presence or absence of balance sheets reviewed by an auditing firm).[2]

Italian Securitization Vehicles. Italian securitization vehicles[3] may lend to businesses[4] to the extent that:

- The borrower is identified by a licensed bank or a financial intermediary;
- The licensed bank or the financial intermediary identifying the borrower retains a "significant interest" in the financing transaction for the entire life of the loan; and
- The notes issued to fund the financings granted by the securitization vehicle are addressed to "qualified investors" only.[5]

The Law Decree grants the Bank of Italy the power to adopt implementing measures on financings granted by Italian securitization vehicles, and on March 6, 2015, the Bank of Italy issued—for consultation purposes only—a draft pertaining to these measures.

The consultation term will expire after 60 days from the publication date. Italian securitization vehicles will be able to lend into Italy once the Bank of Italy's Law Decree implementing measures enter into force.

Italian Alternative Investment Funds. Italian investment funds carrying out lending activities qualify as alternative investment funds pursuant to Directive 2011/61/EU of June 8, 2011 on alternative investment funds managers ("AIFMD") as implemented into Italy.

The Law Decree broadened the alternative investment fund notion set out by the Italian Unified Financial Act[6]—which is the level 1 measure implementing the AIFMD—so that alternative investment funds could lend into Italy to borrowers other than consumers and microenterprises.

Pursuant to the Law Decree level 2 and 3 implementing measures, issued respectively by the Ministry of Economics and Finance[7] and by the Bank of Italy,[8] alternative investment funds lending into Italy will be formed as closed-ended undertakings and may grant financings without any limit on the financing's scope.

EU Alternative Investment Funds. EU non-Italian alternative investment funds may lend into Italy, on a freedom to provide services basis or via the formation of an Italian branch, provided that they may invest into direct financings pursuant to the laws and regulations of their home country and of Italy, and that direct lending is carried out vis-à-vis entities other than consumers and microenterprises.

Since alternative investment funds lending into Italy fall within the AIFMD scope, non-Italian EU licensed alternative investment fund managers may passport their AIFMD license in Italy, on a freedom to provide services basis or via the establishment of a branch, to form, manage, and fundraise Italian alternative investment funds lending into Italy.

Tax

Broadened Scope of Substitute Tax Regime on Medium-Term and Long-Term Loans. Certain qualifying lenders may elect to subject medium-term and long-term loans to a 0.25 percent (two percent in some cases) lump-sum tax (so-called substitute tax, or *imposta sostitutiva*) that replaces the indirect taxes generally applicable to the loan and the loan documents. The election is available only if the loan has a maturity exceeding 18 months and is made in Italy. The *imposta sostitutiva* is levied on the amount made available.

If the lender elects this option, the loan and the loan documents are exempt from any registration tax, cadastral tax, mortgage tax, or stamp duty that would otherwise apply. The exemption applies not just to the loan itself but also to all deeds, documents, agreements, and formalities incident to the medium-term or long-term loan, its execution, amendment, and redemption, as well as to any guarantees of whatever nature granted by anyone at any time and their subrogation, substitution, postponement, and cancellation.

This elective regime is very favorable if the loan is secured by mortgage because, absent the election, a two percent mortgage tax would apply on the maximum amount secured by the mortgage. Other than for very limited statutory exceptions and "scattered" court decisions, banks were basically the only lenders that could qualify for, and thus elect to apply, *imposta sostitutiva*. In addition, the Italian tax authorities have often taken the position that the *imposta sostitutiva* regime does not cover the subsequent transfers or assignments of the loan and of the related security package. These transfers and assignments were therefore subjected to the ordinary indirect taxes.

The Law Decree broadened the scope of application of the *imposta sostitutiva* regime in two important ways:

- The pool of qualifying lenders now also includes (i) Italian securitization vehicles; (ii) insurance companies that are incorporated and licensed under the laws of an EU Member State; and (iii) undertakings for collective investment (e.g., investment funds) that are set up in an EU Member State or in a European Economic Area ("EEA") country allowing for an adequate exchange of information with Italy (currently, this includes only Iceland and Norway); and
- The exemption from indirect taxes now also covers any subsequent transfer or assignment of the loan, of the receivables from it, and of any related security package.

Repeal of Interest Withholding Tax on Certain Cross-Border Loans. As a rule, if a nonresident lender grants a loan to an Italian resident borrower, interest paid on the loan is subject to a 26 percent withholding tax in Italy,[9] unless the lender is eligible for the exemption under the Italian laws that implemented the EU Interest and Royalties Directive. The withholding tax may be reduced (usually to 10 percent) or, in very few cases, zeroed under the double-tax treaties entered into by Italy, where applicable.

The Law Decree repealed the interest withholding tax in cases of cross-border loans that meet certain requirements. As a result, no withholding tax is now levied on the interest if (i) the loan is a medium-term or long-term loan; (ii) the borrower is an enterprise (e.g., an Italian commercial partnership, a resident company, or the Italian permanent establishment of a nonresident enterprise); and (iii) the lender is any of the following:

- A bank established under the laws of a EU Member State;
- An insurance company established and licensed under the laws of a EU Member State; or
- A foreign institutional investor established in a country allowing for an adequate exchange of information with Italy even if it is not subject to tax in its home country of establishment, and provided that it is subject to regulatory supervision in the country where it has been established.[10]

Because the new rules state that the borrower must be an enterprise, the withholding tax exemption should not apply when the borrower is an Italian undertaking for collective investment (e.g., an Italian investment fund). Moreover, it will have to be clarified in due course whether the withholding tax exemption is available if the borrower is an Italian static holding company.

Conclusions

The Law Decree introduces significant changes resulting in the opening of the Italian direct lending market to additional qualifying lenders. As a consequence, subject to the eligibility requirements set out by law, investors will be able to grant financing in Italy through securitization transactions or through the setup of alternative investment funds—without the need to apply in advance for a banking license. Moreover, the Law Decree may foster synergic relationships between banks and new qualifying lenders to the benefit of the Italian lending market. Finally, foreign investors also may be attracted to invest in Italy by the significantly favorable tax and segregation regimes introduced by the Law Decree.

It is expected that even after the enhancement of the Law Decree, Italian-based and operating banking institutions will still play a crucial role in the Italian lending market, given that they are vested with the task of identifying the potential borrower and are required to keep a significant interest in the financing transaction.

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Endnotes

1 Lending vis-à-vis consumers and microenterprises continues to be reserved to licensed banks and financial institutions.

2 Reference is made to IVASS Regulation no. 22 of October 21, 2014, amending IVASS Regulation no. 36 of January 31, 2011, pointing out the general criteria on the investments of the technical reserves of insurance companies.

3 I.e., any vehicle formed pursuant to Law no. 130 of April 30, 1999.

4 Lending vis-à-vis consumers and microenterprises continues to be reserved to licensed banks and financial institutions.

5 The definition of "qualified investors" set forth under CONSOB Regulation no. 16190 of October 29, 2007, which implements the provisions on intermediaries under the Italian Unified Financial Act (as defined below), includes, among others, (i) Italian and foreign entities authorized and regulated to operate on financial markets (e.g., banks, investment firms, other authorized or regulated financial institutions, insurance companies, and pension funds); (ii) large enterprises (i.e., enterprises satisfying at least two of the following requirements: (a) total assets of at least €20 million, (b) net revenues of at least €40 million, and (c) own capital resources of at least €2 million); (iii) institutional investors whose principal activity is investment in financial instruments, including securitization entities; and (iv) other investors who request to be treated as professional clients, provided that certain requirements set forth by the Italian Unified Financial Act are met.

6 Legislative Decree no. 58 of February 24, 1998.

7 Reference is made to the new Bank of Italy Regulation on collective portfolio management dated January 19, 2015, enacting certain provisions of the Unified Financial Act and replacing the previous Bank of Italy Regulation of May 8, 2012 on collective portfolio management.

8 Reference is made to the new Ministry of Economics and Finance Decree no. 30 of March 5, 2015 enacting certain provisions of the Unified Financial Act and replacing the previous Ministry of Economics and Finance Decree no. 228 of May 24, 1999. It is worth noting that the report to the new decree expressly stated that closed-ended undertakings could carry out direct lending into Italy.

9 Until June 30, 2014, the withholding tax rate was 20 percent.

10 The reference to foreign institutional investors has been amended by Law Decree no. 3 of January 24, 2015.