EUROPEAN CENTRAL BANK

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OPINION OF THE EUROPEAN CENTRAL BANK

of 24 March 2016

on the reform of cooperative banks, a guarantee scheme for securitisations of non-performing loans and the lending capacity of alternative investment funds

(CON/2016/17)

Introduction and legal basis

On 2 March 2016, the European Central Bank (ECB) received a request from the Italian Ministry of Economic Affairs and Finance for an opinion on Decree-Law No 18 of 14 February 2016 on urgent measures concerning the reform of *banche di credito cooperativo* ('BCCs', 'Italian cooperative banks'), a guarantee scheme for securitisations of non-performing loans, tax arrangements relating to crisis procedures, and the collective management of assets (hereinafter the 'Decree-Law'). The Decree-Law must be converted into a law within 60 days of publication, i.e. by 15 April 2016, failing which it is rendered invalid ab initio.

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union, and the third and sixth indents of Article 2(1) of Council Decision 98/415/EC[1], as the Decree-Law relates to the Banca d'Italia and to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the Decree-Law

The Decree-Law contains three elements of interest to the ECB. First, it reforms the Italian BCCs. Second, it introduces a guarantee scheme for securitisations of non-performing loans. Third, the Decree-Law introduces new rules concerning the capacity of alternative investment funds governed by Directive 2011/61/EU of the European Parliament and of the Council[2] and established in Italy (hereinafter 'Italian AIFs') or in another Member State (hereinafter 'EU AIFs') to engage in non-consumer lending activities.

1.1 *Reform of cooperative banks*

1.1.1 The Decree-Law reforms BCCs with the aim of bringing about more transparent and efficient governance standards, and eliminating structural weaknesses in the system of BCCs. It provides

1 Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

2 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p. 1).

for the establishment of Cooperative Banking Groups (hereinafter 'Groups') each led by a parent company.

1.1.2 The Decree-Law requires each BCC to choose between joining a Group or, subject to certain conditions, being converted into a joint stock company. A BCC must join a Group in order to be authorised by the Banca d'Italia to carry out banking business in the form of a BCC. Alternatively, individual BCCs whose net assets exceed EUR 200 million may opt not to join a Group on condition that they become joint stock companies, with the authorisation of the Banca d'Italia, and pay an extraordinary tax of 20 % of their cash reserve.

1.1.3 Each Group must have a parent company, incorporated as a joint stock company, with the majority of its shares held by the BCCs in the group. A parent company must have net assets of at least EUR 1 billion, and be authorised by the Banca d'Italia to carry out banking activities. A parent company primarily directs and coordinates the BCCs in its Group in accordance with the relevant cohesion contract.

1.1.4 Cohesion contracts set out the powers of the parent company, in accordance with the principle of mutuality, including: (i) the power to identify and implement the strategic orientation and operational objectives of the Group adjusted to the risk level of the BCC in question; (ii) the power to approve or reject, in exceptional cases, the appointment of one or more BCCs' board members up to the majority of its members; and (iii) the power to expel a BCC from the Group in the event of a serious breach of one or more of the terms of the cohesion contract, and other types of sanction proportionate to the seriousness of the breach in question.

Cohesion contracts also provide for joint and several guarantees of the obligations assumed by the parent company and the BCCs, in accordance with the prudential regulations of the Groups and individual banks in the Group.

1.1.5 The Decree-Law also amends the rules regarding the capitalisation of individual BCCs as follows: (i) the maximum share capital in a BCC that can be held by a single shareholder is increased from EUR 50 000 to EUR 100 000; and (ii) the minimum number of shareholders of a BCC is increased from 200 to 500.

1.2 *Guarantee scheme for securitisations of non-performing loans*

1.2.1 The Decree-Law provides for the introduction of a State guarantee scheme to cover the senior tranches of securitisation transactions carried out by banks incorporated in Italy and backed by non-performing loans (NPLs). The guarantee scheme will be open to all Italian banks and the guarantee for the senior notes will be priced at market rates and be based on specified credit default swap contracts, in order to ensure compliance with State aid rules. The Minister for Economic Affairs and Finance is authorised to issue guarantees under the scheme for 18 months starting from the date the Decree-Law enters into force, i.e. 16 February 2016. This period may be extended for a further 18 months, subject to the prior approval of the European Commission.

1.2.2 The scheme is based on individual banks seeking to set up a securitisation structure under which NPLs will be transferred at a price no higher than their net book value, i.e. gross value minus provisions. The securitisation structure is financed by issuing senior, mezzanine (optional) and junior notes.

1.2.3 The State guarantee is an unconditional, irrevocable and first-demand guarantee, covering contractual payments for interest and capital, but only for the benefit of senior noteholders. The guarantee will become effective only once the following conditions are fulfilled: (i) the bank appoints an independent NPL servicer to deal with securitisations; (ii) the securities receive a rating equal to or higher than investment grade from a rating agency included in the list of the external credit assessment institutions accepted by the Eurosystem; and (iii) the originating bank has sold to private investors a share of at least 50 % plus one of the junior tranches, and has sold a sufficiently large part of the junior and mezzanine tranches to achieve accounting derecognition of the NPLs sold[3].

1.3 *Lending capacity of alternative investment funds*

1.3.1 Since 2014 the Italian Consolidated Law on finance [4] has provided for the possibility for Italian AIFs to engage in direct lending under certain conditions, specified in Banca d'Italia's regulation[5]: they must have a closed ended structure and are subject to concentration[6] and leverage limits[7]; the maturity of credits cannot exceed that of the fund.

As for internal controls, asset managers are required to define, within the risk management system, a specific process of managing credit risk, with particular regard to: i) risk measurement; ii) risk diversification; iii) credit monitoring; iv) classification of risk positions; v) assessment and management of impaired loans.

1.3.2 The Decree-Law amends the Italian Consolidated Law on finance specifying that credit funds cannot lend to retail consumers and that AIFs' lending activity is subject to rules on transparency. It also extends the possibility to grant loans to EU AIFs under the following conditions: (i) EU AIFs are authorized by the competent authority of the home Member State to grant loans in the home Member State; (ii) EU AIFs adopt a closed ended structure and their operating model, including the rules of participation, is comparable to that of Italian AIFs; (iii) the prudential regulation of the home Member State, including limits to leverage, are deemed equivalent to those applied to Italian AIFs. The assessment of equivalence is carried out by Banca d'Italia and can be based on the contractual provisions governing the AIFs. The home competent authority must ensure that the EU AIFs comply with such provisions.

1.3.3 Without prejudice to the foregoing, the Banca d'Italia is obliged to lay down detailed rules to be applied to EU AIFs engaging in direct lending in Italy. In any case, the Banca d'Italia has the power to veto EU AIFs engaging in direct lending in Italy. If no veto is imposed, EU AIFs operating in Italy will be also required to comply with Italian conduct of business rules governing transparency of contractual terms and client relationships.

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3 No State body may buy junior or mezzanine notes.

4 Testo Unico della Finanza, Decreto Legislativo (24.02.1998, n. 58).

5 Regolamento sulla Gestione collettiva del risparmio (19.1.2015).

6 The exposure to a single client is subject to a limit of 10 per cent of the total assets of the fund.

7 More specifically, AIFs marketed to retail customers are subject to a leverage limit of 1.3 (calculated as the ratio between the total assets and the total net value of the fund) and can enter into derivative contracts exclusively for hedging purposes, whereas AIFs marketed to professional investors are subject to a leverage limit of 1.5.

2. The appropriate time to consult the ECB

2.1 The ECB must be consulted at an appropriate stage in the legislative process. Consultation should therefore take place at a time that enables the relevant national authority to take the ECB's opinion into account before the provisions in question are adopted[8].

2.2 In the Italian legal system, a decree-law enters into force when it is adopted by the Government. It takes effect following publication in the *Gazzetta Ufficiale* and must be submitted on the same day to Parliament for conversion into law. If not converted within 60 days of publication, the decree-law is rendered invalid ab initio. Amendments may be introduced during the conversion process. In the light of the foregoing, the ECB should be consulted before the adoption of a decree-law[9].

2.3 In the present case, as the Decree-Law was adopted on 14 February 2016 and published on 15 February 2016, not only was the ECB not consulted before its adoption, but the submission of the consultation request was unnecessarily delayed. The request was received by the ECB on 2 March 2016, when the Ministry of Economic Affairs and Finance asked the ECB to consider the consultation as a matter of urgency in view of the short deadline for conversion. This situation is unfortunate and the ECB would like to emphasise to the Ministry the need for proper consultation.

3. Observations

3.1 *Reform of cooperative banks*

3.1.1 It is recalled that the ECB was consulted and issued an opinion on Decree-Law No 3/2015 on urgent measures for the banking system and investments, which introduced significant reforms of 'popolari banks'[10]. The reform of cooperative banks is part of the same reform of the banking system.

3.1.2 Under the current prudential regulatory framework, both strong governance arrangements and a solid capital structure are crucial concerns for the banking supervisor. To this end, the consolidation of the cooperative banking sector into Groups where the parent company is a joint-stock company would facilitate each Group's ability to raise capital and enhance shareholders' control over management. In addition, this could make it easier for capital instruments issued by the BCCs to fulfil the requirements of Regulation (EU) No 575/2013 of the European Parliament and of the Council[11], as supplemented by Commission Delegated Regulation (EU) No 241/2014[12], for capital instruments to qualify as Common Equity Tier 1 capital. Furthermore, the Group arrangements make it possible for the Common Equity Tier 1 of the BCCs in excess of minimum

8 See Article 4, second sentence, of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42); Title IV, Section I of the *Guide to consultation of the European Central Bank by national authorities regarding draft legislative provisions*, which is available on the ECB's website at: www.ecb.europa.eu.

9 See ECB Opinion CON/2012/64. All ECB opinions are available on the ECB's website at: www.ecb.europa.eu.

10 See ECB Opinion CON/2015/13.

11 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

12 Commission Delegated Regulation (EU) No 241/2014 of 7 January 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for Own Funds requirements for institutions (OJ L 74, 14.3.2014, p. 8).

requirements to be accounted for purposes of compliance with capital requirements at consolidated level.

3.1.3 The ECB expects that the Decree-Law will accelerate consolidation among Italian cooperative banks. This process should eventually result in the cooperative banking sector as a whole having an improved capacity to absorb negative shocks, as well as providing new opportunities for rationalisation of resources and diversification of investments. Given the importance of the Decree-Law in addressing the vulnerabilities of the Italian cooperative banking sector, the ECB generally supports the key elements of the proposed reform.

3.1.4 Nevertheless, the ECB wishes to raise the following points:

3.1.5 First, the establishment of a Group involves significant challenges for the parent company in terms of risk governance and control systems. In this regard, the ECB would like emphasise that, in order to be aligned with best practices at international level, the parent company's powers to manage affiliated institutions and coordinate the Group should be broader than provided for in the Decree-Law. In particular, the parent company should be able to direct and coordinate the Group, including by giving direct instructions to the affiliated institutions under any circumstances to ensure compliance with applicable prudential rules and supervisory requirements as well as to ensure that the group entities' operations and strategies are in line with the Group's policies and objectives. The ECB understands that the powers of the parent company depending on the risk level of each BCC will be clearly specified in secondary regulation and in the "cohesion contracts" in a way to ensure that these powers are strong and effective, in compliance with CRD IV requirements and the best practices. This solution reflects the principle of autonomy of the BCCs which are cooperative companies devoted to a mutual activity according to their special statute. However, in order to safeguard the parent company's effective control of the Group, the power to remove directors should not be limited to exceptional situations.

3.1.6 Second, the ECB welcomes the Decree-Law stipulating that the parent company will have control systems and the power to ensure compliance with prudential requirements, as it is of great importance that Groups have well-designed control functions, including risk management, compliance, internal audit and planning, reporting exclusively to the parent company.

3.1.7 Third, the ECB notes that the provision according to which BCCs can decide whether or not to join a Group may undermine the reform. In particular, as the date by which BCCs must have net assets of at least EUR 200 million is not stipulated in the Decree-Law, there is a risk of promoting mergers between BCCs with net assets below EUR 200 million. Not joining a Group should be an exceptional option which can only be exercised during a limited period of time and measured with reference to the required level of net assets for a BCC on a specific prior date (for example, net assets as at 31 December 2015).

3.1.8 Fourth, pursuant to the Decree-Law, the Banca d'Italia is the authority competent to verify whether the requirement to form a Group has been fulfilled. The Banca d'Italia is also competent to authorise a BCC's membership of a Group, the rejection of a request for membership, the exclusion of a BCC from a Group, and the conversion of a BCC into a joint stock company. Where

the relevant authorisations are not granted, the BCC must commence liquidation proceedings[13]. Further, in the event of non-compliance with the requirement to form a Group, the Banca d'Italia is competent to take the actions necessary to revoke the authorisations necessary to carry out banking activities[14]. It is understood that these powers assigned to the Banca d'Italia are without prejudice to the powers assigned, within the scope and framework of Council Regulation (EU) No 1024/2013[15], to the ECB as the authority competent to withdraw authorisations of credit institutions[16] and to ensure compliance with the requirement of Directive 2013/36/EU of the European Parliament and of the Council[17] that credit institutions have in place robust governance arrangements[18].

3.1.9 Finally, two key aspects of the proposed legal framework for Groups concern the procedure for the functioning of the joint guarantee and the minimum organisational requirements for the parent company. Regarding the joint guarantee, there should be sufficient arrangements in place to ensure that committed support will be given when necessary. Regarding organisational requirements, it is critical that the Decree-Law requires adequate corporate governance measures to be in place in order to ensure that the parent company is able to meet its dual mandate as oversight body of the affiliated BCC and as executive body of the entire Group. The ECB notes that it is the intention of the Italian government to further develop these aspects in a ministerial Decree. The ECB would appreciate being consulted in advance of the final approval of this Decree.

3.2 *The guarantee scheme for securitisations of NPLs*

3.2.1 The ECB welcomes the guarantee scheme for securitisations of NPLs as it may lead to a reduction of funding costs for such securitisations, which would allow NPLs to be recognised with a higher value and thus incentivise the transfer of NPLs. From a financial stability point of view, the presence of significant volumes of NPLs on credit institutions' balance sheets reduces their ability to fulfil their function as providers of credit to the real economy and hampers operational flexibility and overall profitability essential to a well-functioning banking sector. As such, the scheme may have a positive, albeit incremental, effect on financial stability to the extent that it would result in transfer of the risks of NPLs off credit institutions' balance sheets. However, the scheme needs to be seen in conjunction with other measures required in order to address the issues posed by NPLs for credit institutions in a systemic manner.

3.2.2 The ECB notes that the procedure for enforcement of the guarantee, in particular the permitted timing of enforcement claims, set out in Article 11(1) of the Decree-Law should be clarified in order to align the first and second sentences of that paragraph. The first sentence reads as if the guarantee may only be enforced from the date of legal maturity of senior notes until nine months

13 Art. 1(4)(c) of the Decree-Law.

14 Art. 2(4) of the Decree-Law.

15 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

16 Art. 4(1)(a) of Council Regulation (EU) No 1024/2013.

17 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176 , 27.6.2013, p. 338).

18 Idem, see Article 74.

thereafter. The second sentence, however, allows enforcement procedures to be commenced 30 days after a non-payment event, which could also occur prior to the final maturity of the senior notes, e.g. in relation to interest payments. It would therefore seem more logical that the guarantee may be enforced *at the latest* nine months after final maturity of the senior notes, but also prior to final maturity after a non-payment event. The ECB suggests that the wording in the first sentence should be amended accordingly to include the words 'at the latest'.

3.2.3 The ECB further notes that Article 11(2) of the Decree-Law should be amended to clarify both the timing and quantum of payments which should be made by the guarantor under the guarantee. With regard to timing, the ECB understands that, within thirty days from the date of receipt of a documented request for enforcement of the State guarantee, the Minister for Economic Affairs and Finance must undertake payment, and not only upon the maturity of the senior notes. As currently drafted, the amount payable appears to cover only the full amount of principal of the senior notes which would be due at final maturity. This appears to contradict Article 8(2) of the Decree-Law, which indicates that the guarantee covers payments of principal and interest for the entire term of the senior notes, since future interest payments would not be covered. In addition, the ECB notes that the current drafting implies that, even if there were a non-payment event relating only to an interest payment occurring prior to the maturity of the senior notes, the guarantee payment would involve payment of the full amount of principal, prior to that principal becoming due on such final maturity date.

3.2.4 Finally, the ECB also welcomes the Decree-Law requiring the appointment of a qualified independent entity to monitor the compliance of the issued guarantee with stated conditions, the appointment of an independent servicer and the transfer of at least 50 % plus one of the junior notes, and in any case, an amount of mezzanine and junior notes permitting the derecognition of the underlying assets at consolidated level in accordance with Article 8(1) of the Decree-Law.

3.3 *Lending capacity of alternative investment funds*

3.3.1 In general, alternative investment funds (AIFs) which are entitled to grant loans carry out a typical banking activity outside the regulated banking system (i.e. without being subject to Regulation (EU) No 575/2013 and Directive 2013/36/EU or comparable prudential regulation). AIFs might therefore act as substitutes for bank lending and could generate credit intermediation risks (i.e. runs and/or liquidity risk) without having a banking (or comparable) licence. While regulated indirectly as a result of initial capital, own funds and internal controls requirements imposed on their asset managers under Directive 2011/61/EU, AIFs are not subject to harmonised rules on concentration risks and credit assessments[19].

3.3.2 In light of these considerations, it should be ensured that the direct provision of loans by AIFs is subject to targeted measures efficiently mitigating the associated risks. The ECB thus welcomes that Italian legislation[20] provides for rules applicable to lending activities of both EU AIFs and Italian

19 See European Banking Authority Guidelines 'Limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013' of 14 December 2015 (EBA/GL/2015/20), p. 10.

20 Regolamento sulla Gestione collettiva del risparmio (19.1.2015).

AIFs on managing credit risk with regard to risk measurement and diversification, leverage, fund structure as well as credit monitoring, classification of risk positions and assessment and management of impaired loans.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 17 March 2016.

[signed]

The President of the ECB

Mario DRAGHI