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The Changing Face of Italian Insurance Companies

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Italian insurance companies have been given a key role to play in the attempt to revive credit to the real economy in Italy. Recent reforms have widened the range of investments which they can use to cover their technical provisions and have enabled them to engage in direct lending. IVASS (the industry regulator) has now issued the regulations implementing these reforms, thereby completing the new legal framework applicable to the operations and investments of Italian insurance companies.

I. Direct Lending

Building on trends which have emerged in the context of the implementation of the Solvency II Directive[1], Italian Law Decree 91 of 24 June 2014 ("Decree 91")[2] has for the first time enabled Italian and EU insurance companies to lend in Italy. IVASS Resolution No. 22 of 21 October 2014, amending Regulation No. 36 of 31 January 2011 on eligible assets and investments to cover technical provisions (the "Regulation"), has now complemented the provisions of Decree 91 applicable to Italian insurance companies as follows:

A. Process

1. Insurance undertakings who wish to engage in direct lending should prepare a specific business plan (the "Lending Business Plan"), which is subject to a 90-day vetting process by IVASS, during which IVASS can set *ad hoc* qualitative and quantitative limits to the lending operations of the undertaking concerned.

2. Once it has been authorised by IVASS, the Lending Business Plan should be formally approved by the board of the insurance undertaking and thereafter the undertaking can start operating in the lending market.

3. With regard to the direct loans held by them, insurance undertakings will be required to submit to the Bank of Italy, including through a bank or a regulated financial intermediary, all the periodical submissions and any other document and data which are required of Italian banks and should take part in the default reporting and monitoring system managed by the Bank of Italy (the so-called *Centrale dei Rischi*).

B. Borrowers and Loan Terms

1. No lending can be made to individuals or to micro-enterprises[3].

2. In accordance with Decree 91, in the Lending Business Plan insurance undertakings can choose whether:

   - they will rely on the assistance of a bank or a regulated financial intermediary for the selection of the borrowers (the "Bank Partner"), in which case the Bank Partner should hold a 5% economic interest in the loans until maturity, which can be transferred to other banks or financial intermediaries during the term of the loan; or

   - they will independently carry out the selection of the borrowers, without relying on a Bank Partner, in which case, *inter alia*, the insurance undertaking should set up internal processes for the management of credit risk which are equivalent to those required by the current banking regulations and best practices.

3. In any case, the Lending Business Plan should detail the criteria for the selection of the borrowers and for the granting and management of credit, determining in particular the credit worthiness of the borrowers[4], their legal form, size range, industry sector and geographical location, the duration and purpose of the loans, the security interests, guarantees and covenants to be included in the loan agreements; where the insurance undertaking uses a Bank Partner, these selection criteria, as well as the process for their review, should be spelt out also in the *ad hoc* agreement to be entered into between the insurance undertaking and the Bank Partner.

4. Finally, the Lending Business Plan should also detail the target loan amounts and the concentration limits at the borrower individual and group level.

C. Capitalization

Both upon authorisation of the Lending Business Plan and upon monitoring of its implementation, IVASS is called to check that the insurance undertaking is sufficiently capitalised, particularly as regards the level of coverage of the solvency capital requirement and the calculation of the capital charges applicable to direct loans, which will be required by the forthcoming Solvency II regime.

D. Eligibility to Cover Technical Provisions

Direct loans held by Italian insurance undertakings can be used as assets to cover their technical provisions. Significant policy choices have been made in the Regulation on the extent to which the different types of loans can be eligible for this purpose, and these are bound to influence the lending operations of Italian insurance undertakings. In our view the points of particular interest are:

1. no more than 20% of the technical provisions can be covered with direct loans, this being the overall size of the direct loans bucket; in any case the amount of an insurance undertaking's participation in a single loan should not be higher than (x) 20% of the borrower's net equity and (y) 1% of the insurance undertaking's technical provisions.

2. loans secured by real estate mortgages (where the LTV is not higher than 60%), or by first demand bank guarantees or insurance policies or by state guarantees, are favoured as they can represent up to 20% of the technical provisions (i.e., the full size of the direct loans bucket), whether or not they are originated with the assistance of a Bank Partner;

3. other loans can be used to cover only up to 5% of the technical provisions and are further divided into sub-buckets, depending on the credit worthiness of the borrower and on the amount of net economic interest retained by the Bank Partner. In particular:

(x) loans made to borrowers having high credit rating and audited financial statements, where the Bank Partner retains at least a 50% economic interest on a *pari passu* level with the insurance undertaking, are given the most favourable treatment; while (y) loans originated without the intervention of a Bank Partner can be used to cover technical provisions only to the extent specifically authorised by IVASS upon approval of the Lending Business Plan of the relevant insurance undertaking.

Therefore, as widely anticipated, IVASS has taken a conservative approach and has directed Italian insurance companies towards safer forms of lending and favoured the business model which envisages the involvement of, and reliance upon, a Bank Partner. This appears to be in recognition of the fact that most insurance undertakings are unlikely to have the expertise required to do the corporate analysis necessary to minimize default risk in respect of investments, such as direct loans, which are less liquid and less credit worthy than the investments traditionally reserved to Italian insurance companies.

II. Investment in Alternative Investment Funds

Since 2007, Italian insurance companies have been allowed to invest up to 10% of their technical provisions in non-UCITS investment funds. However, due to the barriers to the marketing of these sub-funds in Italy which existed in the pre-AIFMD regime[5], the investment process had proven prohibitively complex as it was required that either (i) the relevant fund had been formally authorised for marketing in Italy by the Bank of Italy (which was extremely rare), or (ii) absent formal authorisation, the insurance company had to be satisfied that the fund met all the conditions to which the Bank of Italy's authorisation was subject (which normally led to a request for, and long negotiations of, legal opinions from the fund's legal advisors).

Now that the implementation of the AIFMD in Italy is well underway[6], the Regulation expressly allows investments in Italian and EU alternative investment funds ("AIFs"), upon the sole condition that these AIFs comply with the requirements for the establishment and marketing thereof as set out in the Italian Consolidated Financial Act. With regard to EU AIFs managed by EU fund managers, in our view this should mean that, other than in cases of reverse enquiry, such AIFs should first be passported into Italy pursuant to Article 32 of the AIFMD, which is a much leaner process than the one applicable before this change and should open significant new marketing opportunities for foreign investment managers. The same should also apply in the future to EU AIFs managed by non-EU fund managers, once the authorisation and passport regime under Articles 37 to 41 of the AIFMD is implemented at EU level, whilst non-EU AIFs are currently excluded from the range of eligible assets.

The Regulation also expressly allows investment of the technical provisions in structured notes linked to AIFs, provided that the underlying AIFs satisfy the conditions set out above.

Finally, in line with the recent policy trend of favouring securitisations and corporate bonds, the Regulation has introduced significant exceptions to the 1% concentration limit for exposures to a single AIF: the limit is raised to 2% for infrastructure and energy funds and to 3% for funds which mainly invest in unrated asset-backed securities issued by Italian securitisation vehicles or in bonds and commercial paper issued by listed or unlisted corporates.

III. Other Assets Eligible for Investment

The Regulation confirms the recently introduced ability for Italian insurance companies to invest their technical provisions in:

1. asset-backed securities issued by Italian securitisation vehicles[7]. In particular, up to 5% of the technical provisions can be invested in such securities, even if unrated and

unlisted, across the range of transactions currently falling within the remit of Italian securitisation vehicles: (x) purchase of existing receivables; (y) subscription for or purchase of corporate bonds or commercial paper; and (z) direct lending[8].

2. corporate bonds, including so-called minibonds[9] and Italian project bonds. In particular, up to 3% of the technical provisions can be invested in each of the corporate bonds and Italian project bonds buckets. There is no requirement that corporate bonds be listed, which should therefore enable Italian insurance companies to become significant investors also in private placements of so-called minibonds.

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1 Directive 2009/38/EC; we refer in particular to the various proposals to apply to real estate lending more favourable capital charges than those applicable to direct property investments.

2 Decree 91 was converted into law by law 116 of 11 August 2014 and is effective in its final form as of 21 August 2014. For an overview of Decree 91 and of the erosion of the lending restriction, please refer to our previous July 2014 client alert "*Italy Introduces Measures to Facilitate Alternative Funding*" http://www.paulhastings.com/publications-items/details/?id=b185e169-2334-6428-811c-ff00004cbded.

3 Microenterprises are defined as enterprises which employ fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million.

4 In this respect the Regulation provides that, where a Bank Partner is used, the insurance undertaking can rely on the assessment of credit risk performed by it.

5 For an overview of the pre-AIFMD regime, please refer to our September 2013 client alert "*Implementation of the AIFMD in Italy—First Ground-Breaking Steps*" http://www.paulhastings.com/docs/default-source/PDFs/stay-current_implementationofaifmdinitaly.pdf.

6 Please refer to our July 2014 client alert "*Implementation of the AIFMD in Italy—Closer to the Finishing Line*" http://www.paulhastings.com/publications-items/details/?id=d691e169-2334-6428-811c-ff00004cbded.

7 I.e., securitisation vehicles which are incorporated and operate pursuant to Italian Law 130 of 30 April 1999.

8 For more details please refer to our previous July 2014 client alert "*Italy Introduces Measures to Facilitate Alternative Funding*" http://www.paulhastings.com/publications-items/details/?id=b185e169-2334-6428-811c-ff00004cbded.

9 I.e., corporate bonds issued by non-listed companies.