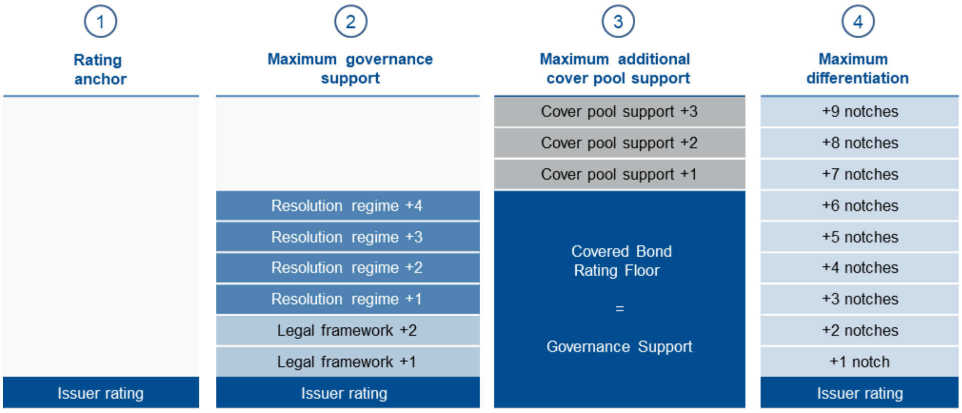
# Legal framework analysis: Italy
## Obbligazioni Bancarie Garantite (OBG)

**Italy's updated covered bond framework is strong and robust. The 31 March 2023 final transposition of the European Covered Bond Directive does not significantly alter our view of the strength of governance support factors common to Italy's covered bonds and their issuers.**

Italian mortgage covered bonds can achieve the maximum six-notch governance support uplift according to our covered bond methodology. Governance support provides a floor to how much a covered bond can be rated above its issuer's rating and constitutes an anchor for additional credit differentiation based on cover pool support.

**Figure 1: Maximum rating differentiation for Italian covered bonds**




Source: Scope; credit differentiation is expressed as a rating notch above the issuer's rating.

Our positive view of the strength of the Italian legal framework generally translates into the maximum two-notch uplift. The assessment remains unchanged following enactment of the secondary legislation on 31 March 2023. This finalised the transposition of the European Covered Bond Directive (CBD) into local law and ensures that Italian covered bonds can be granted the "European Covered bonds (Premium)" label.

In itself, the update provided only limited changes to the existing framework. Market standards such as the requirement to provide regular investor information have been codified and regulatory oversight has been strengthened.

Our resolution regime assessment for Italian covered bonds remains unchanged and allows for an additional uplift of up to four notches. This is based on our view of how regulators would maintain the issuer and its covered bonds upon regulatory intervention, the preferential status of covered bonds in a resolution scenario as well as their systemic importance.

We classify Italian mortgage covered bonds as a systemic refinancing product for domestic banks while public-sector covered bonds are a niche to which we attribute low systemic relevance and thus lower uplift. The uplift assessment of individual issuers will mainly hinge on their resolvability as well their regular covered-bond issuing activities.

Additional cover pool support can lift ratings up to nine notches above the issuer rating. The cover pool support uplift is a function of the interplay between the complexity of a covered bond programme and the transparency that issuers provide to investors, as well as the credit and market risk profile of the cover pool and covered bonds.

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**Related Methodology/Research**

Covered Bond Rating Methodology
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## Legal framework assessment

Strong legal covered bond framework

The Italian covered bond framework meets Scope's criteria for providing Italian covered bonds with the highest, two-notch credit uplift as set out in our methodology. See Appendix I for key features of the Italian framework.

### Legal covered bond framework

There is no dedicated covered bond legislation in Italy. Instead, the covered bond framework (Italian law 130) builds on the Italian securitisation law. With the amendments of that law in 2021[1], legislators transposed the European Covered Bond Directive (Directive (EU) 2019/2162) and the corresponding parts of the Regulation (Regulation (EU) 2019/2160). As some provisions were missing the most recent secondary legislation, 'Circular 285', fully transposed the Directive into local law.

The regulation allows mixed cover pools for Italian covered bonds (Obbligazioni Bancarie Garantite, OBG), but it is market practice to have dedicated covered bond programmes for different cover-pool asset types. Cover-pool eligibility criteria in programme documentation prohibit a mix of different cover asset types.

### Maintenance of a cover pool with low credit risk

Cover pool eligibility requirements

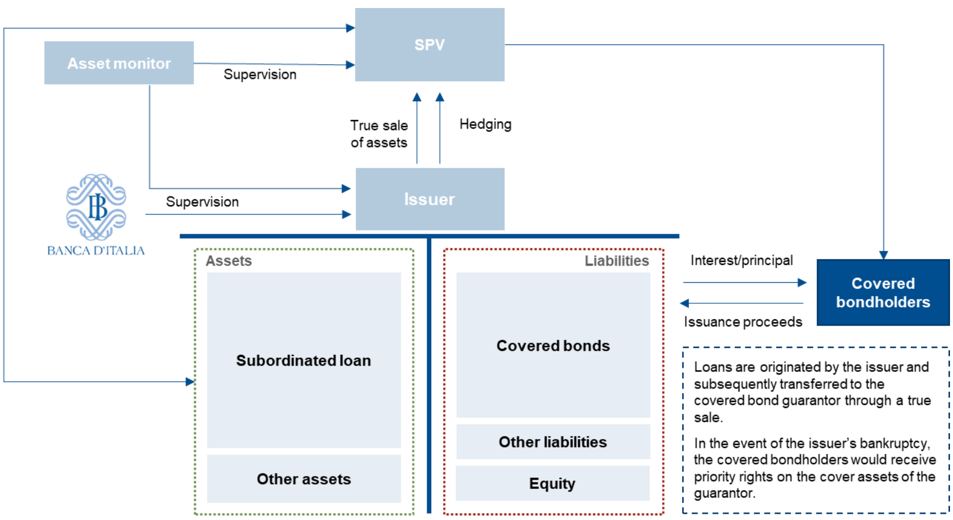
The definition of eligible cover pool assets is in accordance with European standards. Mortgages have a loan-to-value (LTV) limit of 80% for residential and 60% for commercial properties. Non-performing loans can be maintained in the cover pool but will not be included in regulatory coverage tests. Set-off risk is not eliminated by law but it is common market practice to include adequate remedies in programme documentation, like the provision of additional collateral to cover for such risks.

### Segregation of cover pool

SPV-structure effectively ring-fences cover assets

The cover pool is effectively segregated via a true sale to an SPV (the guarantor). The guarantor has a single purpose: to purchase cover assets from the issuing bank financed by a subordinated loan and to provide a guarantee to the issued covered bonds. The law, in combination with contractual agreements, mitigates potential clawbacks.

**Figure 2: Stylised issuance structure**




[1] Legislative Decree No. 190 of 5 Nov. 2021 (the "Decree 190") amended relevant sections of Italian Law 130 that govern Italian covered bonds

In case of an issuer default, the guarantor is obliged to ensure timely payments to investors as stipulated by programme documentation. In addition, covered bond investors have a claim on the general insolvency proceedings of the issuer. Issuer insolvency will not directly result in an acceleration of covered bonds.

Acceleration is only foreseen in case of a guarantor default, for example after a contractual payment to covered bond holders was missed or the value of the cover pool falls below the nominal amount of outstanding covered bonds i.e. the amortisation test was breached.

### Ability to continue payments following issuer insolvency

**Framework also stipulates timely payment after 'insolvency'**

At the inception of the programme, covered bond holders appoint a 'Representative of the Covered Bondholders' (RoCB). Following issuer insolvency, the RoCB will appoint several other parties to ensure timely payment according to the terms and conditions, like a servicer or a portfolio administrator. If cover pool proceeds are not sufficient, the portfolio administrator can set up asset sales to bridge temporary liquidity shortfalls.

Some of the recently established covered bond programmes also include conditional pass-through (CPT) structures that further support mitigating liquidity shortfalls.

### Programme enhancements remain available

**Non-mandatory minimum OC potentially endangers "Premium" status**

Unlike most other European covered bond regimes, Italian covered bonds have a zero over-collateralisation (OC) requirement on a nominal and net present value (NPV) basis. But complying with the Italian law means they cannot be labelled as "European covered bond (premium)".

Preferential regulatory treatment for investors hinges on the issuer committing to an OC of at least 5%. While contractual commitments are legally binding, issuers in distress might be more inclined to remove such commitments; in particular if they do not result in getting their licence or ECB eligibility withdrawn.

**Derivative Counterparties can be as low as BBB-**

As is typical for most covered bond jurisdictions, derivatives in the cover pool will not terminate upon the issuer's insolvency and will remain available to service the covered bond programme. Derivatives continue to rank pari passu with other covered bonds. The CBD has made previous and "voluntary" counterparty replacement mechanisms for derivatives mandatory. However, in contrast to most European countries where such counterparties are rated Single A minus and higher, Italian legislators allow for derivative counterparties and volumes of up to 8%[2] provided they comply with credit quality Step 3 (BBB rating category).

### Liquidity and other risk management guidelines

**Sale of cover assets and bridge financing possible**

The new regulations have clarified that covered bond issuers must provide a liquidity buffer that corresponds at least to net liquidity outflows in the OBG programme over 180 days. The calculation is broadly in line with European standards. In general, it is determined by maximum cumulative daily net liquidity outflows. Unlike in other countries, Italian issuers can simplify by using 13 defined maturity bands.

The beneficial impact for investors is limited as the regulation allows the calculation to be based on the extended maturity of covered bonds (if applicable). With 12-month extendable soft bullet covered bonds being market standard, this effectively means that most issuers do not need to provide additional collateral for the liquidity buffer.

[2] Measured as the nominal volume of derivatives compared to the outstanding amount of covered bonds.

The new framework continues to allow for conditional pass-through covered bonds. However, with much less beneficial ECB treatment, we believe this will result in their gradual extinction in Italy.

### Transparency

**Regular transparency now mandatory**

The Italian framework now stipulates the mandatory cover-pool disclosures that have to be published on the issuer's website at least on a quarterly basis. The required information must meet the minimum requirement under the EU's Capital Requirements Regulation (CRR). The framework also allows that such information can be provided using the ECBC's Harmonised Transparency Template, which an increasing number of issuers already do.

### Covered bond oversight

Covered bond programmes are supervised by the Bank of Italy. While new issuance programmes are subject to prior authorisation, issuers using existing programmes are only obliged to notify the Bank at least 30 days before their first new issue and to show that they comply with the new regulations.

Authorisation is subject to the programme's ability to protect investors, issuers' IT infrastructure and operational management. In addition, covered bond issuers are required to appoint an external asset monitor to perform regular cover pool audits.

## Resolution regime assessment

**Italian covered bonds can receive up to four notches of resolution regime uplift**

Italian covered bonds can receive an additional credit uplift of up to four additional notches based on our resolution regime and systemic support analysis. Covered bonds are excluded from bail-in and issuers benefit from sound business models and high capitalisation, both factors making it likely that regulators will restructure and maintain the issuer and its covered bonds should intervention become necessary.

Scope views Italy as a 'covered bond intense' country and assigns covered bonds high systemic importance. In addition, we observe strong cohesiveness among domestic stakeholders, including support from the central bank.

### Translation of BRRD into national law

**Covered bonds exempt from bail-in**

One notch of uplift reflects the exclusion of Italian covered bonds from bail-in. With Legislative Decree 180 of 16 November 2015, the Italian legislator translated the EU's Bank Recovery and Resolution Directive (2014/58/EU – BRRD). Under this regime, covered bonds and related derivatives are exempt from write-downs.

### Ability to maintain the issuer and its covered bonds as going concern

**Issuer-specific considerations need to be considered**

One additional notch generally reflects whether we believe that the issuer's business model, systemic importance, liability and capital structure, or level of bail-in-able debt, are likely to allow and incentivise regulators to use available resolution tools to restructure most covered bond issuers. We assess on an issuer-specific basis the likelihood of a covered bond programme to be maintained as a going-concern funding instrument.

In recent history, the government has already proven its intention to avoid bank liquidations if possible. For example, in late June 2017, the ECB declared two mid-sized banks in the Italian region of Veneto as 'failing or likely to fail'. While the Single Resolution Board advised that the banks should be liquidated under the Italian insolvency regime, the Italian government decided to transfer performing assets and senior liabilities to Intesa Sanpaolo, including the provision of public guarantees.

## Systemic relevance of covered bonds in Italy

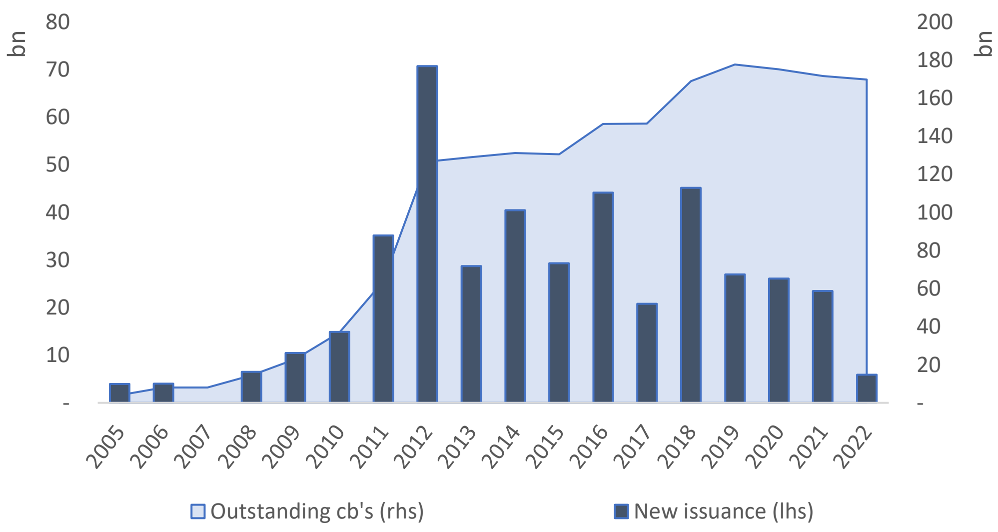
**High systemic importance**

We classify Italian covered bonds as a systemic refinancing product, especially for residential mortgages: 41% of domestic residential mortgages are refinanced via covered bonds and their combined outstanding volume accounted for more than 10% of domestic GDP at the end of 2022.

Annual issuance typically ranges between EUR 20bn and EUR 40bn but was at a low at only EUR 6bn as of year-end 2022. We do not see as credit negative the fact that Italian issuance has significantly dropped and issuers ceased issuance in 2023 up to the final transposition date of the covered bond legislation. This is a technical hibernation owing to the missing secondary legislation which did not allow issuers to update their programme prospectuses.

The stock of outstanding Italian covered bonds amounted to about EUR 170bn at year-end 2022. Internationally, Italy has the seventh largest covered bond market. Currently more than two-thirds of outstanding covered bonds are private placements, indicating they are used as a preferred, self-issued collateral and used for ECB repo transactions including TLTROs.

**Figure 2: Italian covered bonds issuance**




Source: ECBC. Scope Ratings

## Covered bonds used by all larger banks

**13 issuers with 22 programmes, evidencing widespread use**

As of end-2021, 13 Italian banks actively issued covered bonds with 22 individual programmes in total. Italian issuers often maintain more than one covered bond programme to allow for clear distinction between asset classes or maturity structures (CPT vs soft bullet). All internationally-operating banking groups and most of the larger, domestically-focused banks actively refinance residential mortgages via covered bonds.

We expect covered bond-specific support to be forthcoming for most regular and internationally active issuers. The rationale for support might be weaker for small to mid-size and solely domestically-focused issuers. We are likely to assign lower credit differentiation to covered bond programmes that are only opportunistically and irregularly used despite the product's generally high systemic importance.

## Stakeholder support

**Cohesive stakeholder group allows additional uplift**

No specific covered bond stakeholder group exists in Italy. Instead, the Italian Banking Association (Associazione Bancaria Italiana, ABI) represents interests. Scope has observed sufficient cohesive activities, especially during law-setting processes by most stakeholders. We also see a strong incentive at the Bank of Italy to preserve covered bonds as a vital funding instrument.

First, given the widespread use of covered bonds to refinance residential mortgage lending. Second, given the direct exposure on the central bank's balance sheet as Italian banks regularly use covered bonds as collateral for repurchase operations.

Covered bonds provide internationally operating banks with even more beneficial funding costs than for the sovereign. Systemic importance, stakeholder cohesiveness and status in resolution can support an additional uplift of up to four notches according to our methodology. Issuer and covered bond-specific considerations could result in downward adjustments, related to our view of issuer resolvability, the importance to issuers of covered bond funding and the domestic relevance of the particular type of covered bond.

## Appendix I: Key characteristics of the Italian covered bond framework

**Issuer**

The Italian framework requires new covered bond issuers to have a dedicated licence provided by the Bank of Italy. Issuers using existing programmes are only obliged to notify Bank of Italy at least 30 days before their first new issue and to show that they comply with the new regulations.

Effective cover-pool segregation is established though an SPV-structure, whose sole purpose is the purchase of cover assets. The SPV then grants a guarantee to the issued securities over which bondholders have a senior claim.

The issuer does not need to be the originator. Issuers can also pool cover assets originated by other banks. Typically, this is established though a joint issuance vehicle by members of the same banking group.

**Cover assets**

Mortgage assets: residential and commercial assets within the EEA or Switzerland; no restriction on respective shares. Pools generally only comprise domestic assets as stipulated by programme documentation.

Exposures to public-sector entities or public-sector-guaranteed entities in the EEA or Switzerland. For exposures outside of these regions, the framework requires a 0% risk-weight, and a maximum 20% risk weight for public bodies not carrying out economic activities (*organismi pubblici non economici*).

Substitute assets (maximum 15%) can comprise exposures to eligible public-sector issuers, bank deposits and cash.

Derivatives: only to hedge risk. Derivatives can be part of the cover pool. The credit quality of counterparties can be as low as “Credit Quality Step 3”, translating into a minimum rating of BBB minus.

**Loan-to-value restrictions**

Residential mortgages have an LTV limit of a maximum of 80% at market value; commercial mortgages have a maximum LTV limit of 60%.

Property values must be re-assessed every three years for residential and every year for commercial properties. Otherwise, there are no covered bond-specific valuation guidelines. Each bank can set its own criteria but these need to be approved by the Bank of Italy. In the event of a decline in house prices and a higher-than-eligible LTV, loans do not need to be de-registered and can be kept in the cover pool. The same also applies to non-performing loans. However, only the eligible proportion can be accounted for when calculating coverage requirements.

Covered bond investors have a preferential claim on cover assets.

**Market and liquidity risk guidelines**

Minimum 180 days of liquidity coverage, including interest and principal payments. Calculation can be based on the covered bonds’ soft bullet or conditional pass-through maturities.

**Coverage principle/minimum OC**

0% OC on a nominal and NPV basis. The regulation requires that the value of cover assets must at least equal the value of outstanding covered bonds, both on a nominal and an NPV basis. Issuers typically define higher minimum OCs in their programme documentation.

**Treatment upon insolvency**

Upon issuer insolvency, bondholders will exercise their preferential claim on cover assets in the SPV. Subordinated loans granted to the SPV rank junior to claims of covered bondholders and swap counterparties. We expect no immediate acceleration of the covered bonds after an issuer default.

Today, most Italian covered bonds have a 12-month maturity extension together with a portfolio administrator, which has the right sell parts or the entire cover pool to facilitate timely payments. Additionally, some issuers have also established dedicated CPT covered bonds.

**Mandatory transparency**

The Italian framework now stipulates mandatory cover-pool disclosures that have to be published on the issuer's website at least quarterly. The required information must meet the minimum requirement under the EU's Capital Requirements Regulation (CRR).

**CRR compliance**

Italian covered bond types generally comply with the European CRR and are eligible for Liquidity Coverage Ratio purposes.

**Trustee/special supervision**

Covered bond programmes are supervised by the Bank of Italy. In addition, covered bond issuers are required to appoint an external asset monitor, which performs regular cover pool audits.

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