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INSIGHT: Simplified Italian CMBS structures eyed following regulatory reforms.

Italian retail CMBS were among some of the first deals within the structured finance market to suffer negative effects related to COVID-19. The pandemic's effects, alongside structural features of Italian deals that can make them less competitive than other European CMBS, are creating a challenging period for the sector. However, following recent reforms to Italian securitisation law, plans are being drawn up for simpler real estate securitisation structures that could replace traditional CMBS, making the process more cost-effective for the issuer and eliminating the complex enforcement procedures that have typically beset Italian transactions to date.

"As a result of securitisation law reforms, an extreme simplification of the CMBS structure is now likely to provide a solution to the traditional structural issue associated with the length and complexity of the Italian mortgage enforcement procedure," said Norman Pepe, partner at London-based law firm Italian Legal Services.

The maturity of Italian CMBS notes is generally much longer than the maturity of the underlying loan (six to eight years longer), to incorporate the time necessary to realise the asset judicially in a default scenario. Investors in Italian CMBS typically demand a risk premium on the notes to take into account the complexity and unpredictability of the Italian enforcement process.

Changes to the Italian securitisation law in 2019 mean that a securitisation company can now securitise the cash flows, such as rentals, disposal proceeds or insurance indemnities generated by real estate assets acquired by the securitisation company itself. The real estate assets are segregated in favour of the noteholders, meaning that no other creditors should be entitled to enforce their claims while the notes are outstanding.

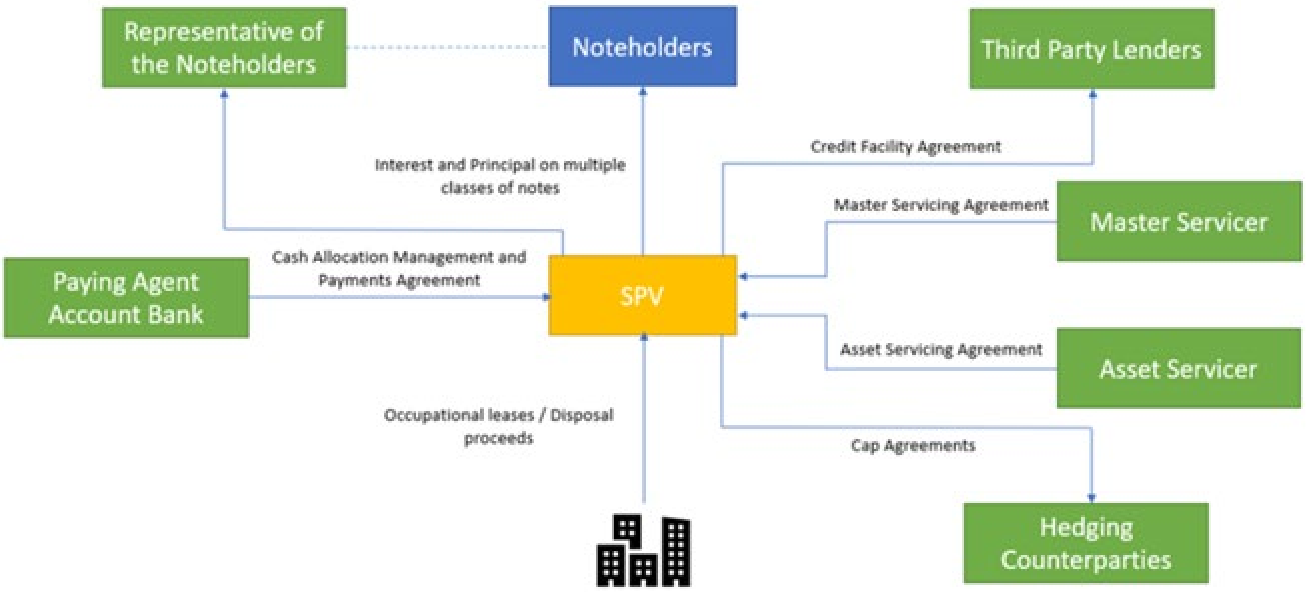
Under the new legal framework the traditional CMBS structure - in which there is an entity acting as owner of the real estate assets and borrower of the securitised loan, as well as a securitisation company acting as lender and issuer of the notes – would be replaced by a new structure where those roles are collapsed into a single entity. The proposed "real estate securitisation company" would issue multiple classes of notes, the junior notes of which would be retained by the sponsor.

In the event of a failure to pay interest on the most senior class of notes, the relevant noteholders should be able to serve an enforcement notice via the trustee and force the real estate securitisation company to sell the underlying real estate assets on the market.

“Based on the inherent features of this enforcement mechanism, the disposal process is expected to be more expedited than a judicial enforcement and raise fewer legal concerns than the mandate to sell, which has, to date, acted as an alternative out-of-court enforcement tool and was contemplated by certain Italian CMBS transactions,” said Fabrizio Occhipinti, partner at Italian Legal Services.

"If the new structure reduces the length and complexity of the Italian mortgage enforcement procedure, it will also reduce the costs associated with it, which in Italy can sometimes reach up to 15% of the recovery amount," commented Mirco Iacobucci, senior vice president at DBRS Morningstar.

Diagram of envisaged Real Estate Securitisation structure:



Source: Italian Legal Services

No risk retention requirement

As well as making the structure more competitive within the European structured finance landscape, the new real estate securitisation structure could have other positive qualities from the perspective of the investor and the sponsor.

"It is arguable that, subject to certain conditions being met, this type of transaction would fall outside the definition of 'securitisation' for regulatory purposes and, as a result, the existence of tranching should not trigger the retention requirement and the associated disclosure and information duties," said Mr. Pepe. "Moreover, the tax neutrality of the 'real estate securitisation company' associated with the cumulation of various roles in it will probably overcome the issue of limited deductibility, under Italian law, of passive interest paid by the borrower to the issuer in the context of more traditional structures."

The new regime has been already used to structure transactions in other segments of the real estate markets, such as for the trading of distressed real estate assets, with or without financing, noted Mr. Pepe. "It is possible that, once the market gets more comfortable with the new tool, it will be become the instrument of choice for certain types of real estate secured lending too," he added.

In early April Fitch downgraded multiple tranches from Italian retail CMBS **Emerald Italy 2019**, **Pietra Nera Uno** and **Deco-2019 Vivaldi,** citing social and market disruption caused by the effects of the coronavirus and the related containment measures. DBRS has meanwhile confirmed the rating on the same three deals, as well as **Taurus 2018-1 IT**, but changed the trend to negative given the impact of the lockdown. So far the deals have met their debt obligations and they do not have immediate refinancing pressure, DBRS said.