

## **Memorandum**

**To:** Mr. Massimo Pariotti, Mr. Andrea Giustiniani, Mr. Antonio Cinque, Mr. Giovanni Artale,  
Ms. Mariarosa La Vecchia  
Banca D'Italia

**cc:** Mr. Alberto Del Din  
Bonelli Erede Pappalardo LLP

**From:** Mr. Conor Downey, Mr. Charles Roberts  
Commercial Mortgage Securities Association

**Date:** 6 April, 2004

**Re:** CMBS Transactions Involving Italian Loans

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The Commercial Mortgage Securities Association (the “**CMSA**”) would like to thank you and your colleagues at the Bank of Italy that have taken the time to meet with its members to discuss the securitisation of mortgage loans secured by Italian commercial real estate.

As requested in that meeting, we respectfully submit this memorandum for your consideration. The purpose of this memorandum is to set forth (1) the principal types of commercial mortgage backed securities (“**CMBS**”) transactions that the members of the CMSA would like to see take place with respect to mortgage loans secured by Italian commercial real estate, based on their experience of the US market and the market in other European countries, (2) the benefits that participants in the CMBS market would envisage to be achieved by such CMBS transactions and (3) the concerns expressed by participants in the CMBS market as to the current Italian framework.

### **Principal Types of Transaction**

The CMSA believes that there currently exists significant opportunities for the development of CMBS secured by Italian commercial real estate loans. The development of such form of CMBS would provide additional capital sources for investors in Italian commercial real estate and therefore enhance the liquidity of such real estate.

Increasing volumes of CMBS issuance should provide greater price transparency for both buyers of commercial real estate assets and investors in bonds backed by commercial real estate cash flows leading to increased liquidity and funding cost reductions. In addition, Italian

CMBS should provide an important additional distribution outlet for Italian and foreign banks and increase their capacity to proactively manage loans held on their balance sheets. In addition, it will provide commercial and industrial companies with better alternatives with respect to the management of their equity interest in real estate assets that they use for their offices and plants.

There are three CMBS structures that are likely to be utilised in connection with the securitisation of Italian commercial mortgage loans: (1) pan-European CMBS involving Italian loans along with loans from other European jurisdictions; (2) Italian multi-loan CMBS; and (3) Italian single loan CMBS. In each case, the issuance for the CMBS will likely exceed €200 million per securitisation.

CMBS differs from other asset classes of securitised products as investors will give more consideration to the actual assets being securitised and their underlying capacity to generate cash flows from lettings. Each CMBS securitisation differs based on the quality of the specific commercial mortgage loans it contains.

Furthermore, CMBS differs from an investment in a real estate fund in the following key respects:

- Static Pools: The pools of loans included in CMBS transactions are “static” pools - the loans will not be substituted for other loans (individual loans may be repaid early or may go into default but the affected loan will not be replaced by a new loan).
- Investor and Rating Agency Review: Investors in CMBS transactions base their investment decisions on their underwriting (and the rating agencies’ assessment) of the quality of the real estate, tenants, loans and borrowers included in the transaction.
- Limited Servicing: The role of servicers in CMBS transactions is limited to monitoring loan performance, collecting amounts due and, if a loan defaults, working out or enforcing the lender’s rights under such loan.
- Sophisticated Investor Analysis and Pricing: CMBS investors are typically large financial institutions which typically include banks, insurance companies and pension funds. They undertake sophisticated analysis of the credit and other risks of each investment and the transactions are priced accordingly. CMBS are typically not sold to private investors.

Set out below is a short description of each of the three possible types of CMBS transactions and a note on the types of investor we believe would be interested in the same.

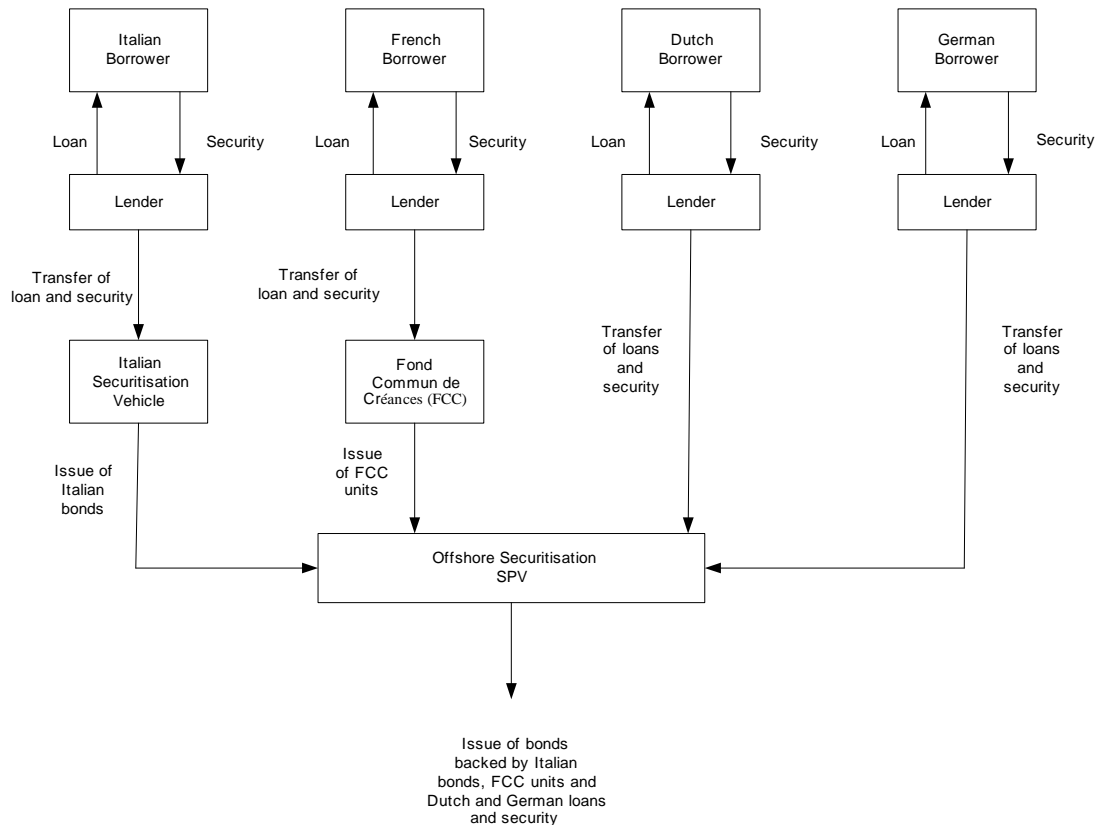
## 1. **Pan-European CMBS**

A number of banks are currently in the process of establishing programmes involving the regular securitisation of portfolios of large commercial mortgage loans made to borrowers throughout Europe, and would be very keen to include Italy among those countries in which they will focus their attention.

This process (often referred to as a CMBS conduit programme) typically involves structuring the mortgage loans to meet certain rating agency criteria in order to achieve optimal rating levels with respect to the CMBS issued in the related securitisation transaction. The applicable rating agency criteria are designed to minimise the effect of external factors on the cash flows produced by the real estate property securing a loan and their application toward amounts outstanding on such loan (e.g. – requiring that all bank accounts holding cash related to such loan be maintained with banks having certain specified ratings).

The bank that originates the mortgage loan will typically arrange the securitisation. Such originating bank will hold the loans until it accumulates a sufficient number of them to warrant a securitisation. When this stage is reached, the bank will transfer the loans (in the manner that most efficiently complies with local laws on transferring loans, the requirements of the relevant bank regulators and the applicable tax regimes) to a special purpose vehicle which is typically not an Italian entity. The “transfer” may be a direct transfer of the loan and security to the SPV or, as is the case in France (and possibly, Italy), a transfer to an intermediate vehicle formed under local law which will issue bonds backed by that loan to the ultimate securitisation SPV issuer.

A diagram of a typical pan-European CMBS transaction is set out below:



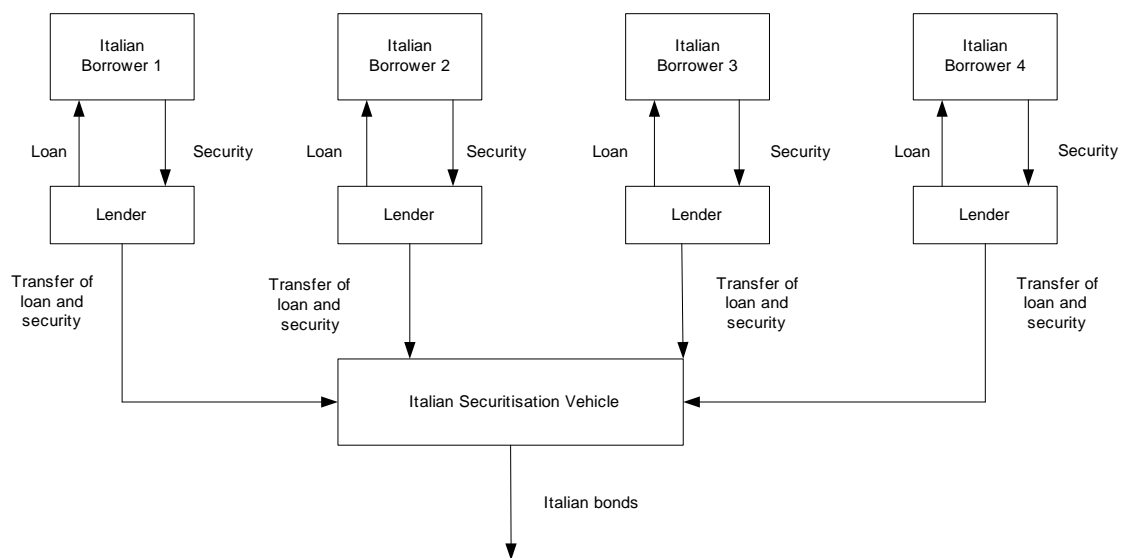
The investors in pan-European CMBS are likely to be similar to those for other forms of European securitisations, i.e. large UK and European banks, pension providers and insurance companies. In addition, we are aware that a number of significant US real estate investors have expressed interest in investing in pan-European CMBS in order to diversify their real estate investment holdings.

## 2. Italian Multi Loan CMBS

We understand that investment banks are seeking to either make new loans to Italian borrowers secured on Italian real property or to acquire portfolios of existing loans from Italian lenders. Again, with respect to any new originations, these loans would be structured to meet rating agency and investor requirements. These loans are likely to be “warehoused” for a period until a sufficient quantity of loans have been accumulated for a securitisation. The resulting pool

would typically include a large number of loans where the respective borrowers are not in any way affiliated with each other. While not always the case, ideally no single loan would represent more than 10 per cent. of the total pool.

A diagram of what could be a typical Italian Multi Loan CMBS transaction is set out below.

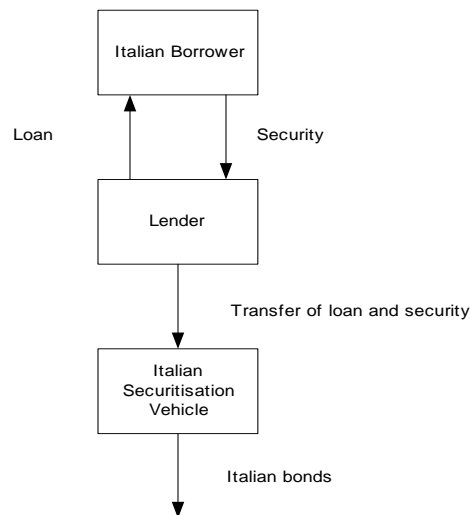


Again, these deals would be likely to also attract the types of investors who invest in other forms of European securitisations, i.e. large UK and European banks, pension funds and insurance companies. In addition, such investor pool is likely to consist of institutions that have a particular interest in Italian real estate.

### 3. Italian Single Loan CMBS

This structure is identical to that described above for possible Italian multi loan CMBS but would only involve one loan. The real differences between single loan and multi loan CMBS is in the significantly higher levels of analysis and due diligence given to the loan, the borrower and the property by the rating agencies and investors. This type of CMBS might be used in a large “sale and leaseback” transaction where the prior owner of either a single large property or a large pool of properties sells it to a SPV and then leases it back.

A diagram of a typical Italian Single Loan CMBS transaction is set out below.



Again, these deals would be likely to attract the types of investors who invest in other forms of European securitisations i.e. large UK and European banks, pension funds and insurance companies, all of which will have interest in investing in Italian real estate. Additionally, in some situations where the commercial real estate is let to investment grade tenants, such CMBS might attract investors in the corporate debt of such tenants.

## **Concerns of Market Participants**

Participants in the European CMBS market have consistently expressed their concerns as to the currently uncertain situation of real estate securitisations in Italy. While in the past a limited number of such transactions have been carried out in Italy, we understand the Bank of Italy to have raised certain concerns, namely the ones outlined below.

### **1. Clawback Risk**

The Bank of Italy has pointed out that uncertainty as to whether the “ringfencing” of assets in an Italian securitisation (i.e. the protection or segregation of the securitised assets from the claims of third party creditors that are not part of the securitisation) is effective in relation to rental payments received by a CMBS borrower from the tenants of its real estate in the event the latter are subsequently subject to a bankruptcy procedure. Italian laws, as they currently stand, protect the securitised portfolios of claims. In the context of CMBS, this would mean that loan repayments received by the Italian securitisation issuer from its borrower(s) would be protected in any case from other creditors of the issuer and would also be protected from a claw back risk further to the insolvency of the borrower(s). However, doubts were raised by the Bank of Italy as to whether payments made by the debtors of the borrower(s) (i.e. the lessees in the case at hand) would benefit of the same protection in the event such debtors became bankrupt.

The rating agencies generally require that the assets of borrowers (as well as issuers) in CMBS transactions be protected from the claims of third party creditors. Where this cannot be achieved, the rating agencies will usually allow fewer highly rated securities to be issued on the back of the relevant real estate loan. This in turn will make the whole transaction more costly to place with investors, and, therefore less attractive to borrowers.

### **2. Balloon Payments**

We understand that another issue raised by the Bank of Italy with respect to the use of Law 130/99 to securitise Italian real estate loans relates to “balloon” payments (typically existing in connection with loans having little or no regular or scheduled repayment of principal over their term but having all or substantially all of their principal repayable in a single lump sum on their final maturity or repayment date, which is expected to be funded by the sale of the real estate assets or through the refinancing of the existing loan on a subsequent date). With respect to such balloon loans, we understand legal issue relates to Law 130/99 being limited to the securitisation of credits as opposed to any other underwritten cash flows that are anticipated during the term of the securities. As a consequence, the Bank of Italy requires that the credits or underlying the mortgage loan to be securitised exist as of the date in which the notes are issued, in an amount not lower than the face value of the notes (net of costs and interest).

Therefore, if the rents under the lease agreements in place for the properties securing the loan are not sufficient to cover in full the repayment of principal on such loan (and, therefore, repayments in principal under the notes), plus interest and costs, the Bank of Italy has required that other contracts (e.g. guarantees) be in place in amounts necessary to pay the remaining amounts due on such loan.

The requirements relating to having credits and the relevant contracts in place on the day of issuance of the notes, as described above, which is the consequence of the wording of Law 130/99, is perceived by market players in CMBS as a major issue in Italian securitisation transactions. In other markets the majority of commercial real estate loans are structured as a securitisation of underwritten cash flows, regardless of whether that is from credits or contracts in place or anticipated in the future. Such structures do not require the placement of any external guarantee from any third party. The risks related to the transaction are isolated, to the best extent possible, to the anticipated performance on the related real estate. The risk relating to the “balloon” payment, or any payment that is due after the expiration of any lease in place, is acceptable in CMBS transactions. It is the intent that such loans are to be repaid through the refinancing of the loan or sale of the underlying real estate to third parties at or prior to its maturity and, to some extent, through the rents under new lease agreements to be entered into upon expiry of the ones in place when the securitisation is closed.

With regard to the investor’s point of view (and without prejudice to the Italian legal issues involved) we would respectfully draw to your attention that investors in CMBS understand this to be a standard element of commercial lending. The risks relating to such balloon payment (which is typically termed as “balloon risk”) are factored into the credit analysis undertaken with any origination or investment in the transaction. The “balloon” is analysed on the basis that it is secured by the vacant possession value of the underlying real estate asset since the balloon is the portion of the original loan which cannot be amortised from rent paid by the tenants (or from the ones in place on the issue date). The balloon element of the loan may cause the loan to bear a higher interest rate to reflect this position. Balloon risk is in fact factored into the underwriting of such a loan by the originator of the loan and the rating agencies and investors in their own analysis of the transaction’s risks. This risk is described in the related offering document for the CMBS. Such risk is part of the consideration for any investor when making an investment decision and is factored into the pricing of the related CMBS.

### **3. A possible solution to the concerns above: Article 2447 *decies* of the Italian Civil Code**

While we understand that there might be technical solutions to address your concerns as outlined above, it has been brought to our attention that the securitisation of mortgage loans complying with the provisions of Article 2447 *decies* of the Italian Civil Code and thus being

able to take advantage of the provisions set out therein would be able in principle to “ringfence” the proceeds of the business financed with the loan and the assets instrumental thereto, and shield the securitisation from any clawback risks relating to the other creditors of the borrower.

We appreciate that Article 2447 *decies* has just recently been enacted and the relevant provisions are being analysed in depth so to ensure that they are able to grant the required protection. We are aware of certain provisions of Article 2447 *decies* which, from a practical point of view, could be less than ideal in light of its use in a securitisation framework, such as the requirement that the loan agreement be filed with the Company Register (which would allow third parties to become aware of confidential information) and the necessity that the borrower is set up as a joint stock company (*società per azioni*) instead of a limited liability company (*società a responsabilità limitata*). However, we would welcome a green light from the Bank of Italy on real estate securitisation structures based on the use of the provisions of Article 2447 *decies* of the Italian Civil Code, i.e. on securitisations under Law 130/99 of mortgage loans complying with the provisions of Article 2447 *decies*.

#### **4. New Sources of Funding for Italian Borrowers**

As a relatively new method of financing real estate, CMBS lending is competing for business with more traditional real estate lenders such as domestic and international banks and property investors. Although CMBS lending can, we believe, offer real advantages to borrowers in terms such as pricing and new sources of funding, the establishment of CMBS lending as an alternative to traditional sources of funding will be significantly hampered if CMBS lending is (or is perceived to be) more difficult to arrange or more costly or restrictive for borrowers than other forms of finance. For competition to flourish, a borrower should be indifferent as to whether a loan will be held on a bank’s balance sheet or securitised. A green light by the Bank of Italy on the use of the above structure in securitisation transactions under Law 130/99 would be crucial in this respect.

We hope that this is helpful for your purposes. If you have any questions or if there is anything else we can do to help, please do not hesitate to contact Charles Roberts (+44 207 170 8727) [charles.roberts@cwt-uk.com](mailto:charles.roberts@cwt-uk.com) or Conor Downey (+44 207 170 8670) [conor.downey@cwt-uk.com](mailto:conor.downey@cwt-uk.com).

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