SUPERVISORY REGULATIONS

COVERED BONDS

Section I

1. Introduction

Article 7-*bis* of Law 130 of 30 April 1999, introduced with Law 80 of 14 May 2005, establishes regulations governing bank bonds collateralized by a specified pool of assets. The new operational scope available to banks meets the need to contain funding costs and to obtain the regulatory benefits available under Community law for funding instruments secured by specified types of guarantees.

Under the new regulations, which are connected to those governing the securitization of claims in Law 130/1999, covered bonds may be issued using a procedure that involves: i) the assignment by a bank, including a bank other than the bond issuer, to a special purpose vehicle of high-quality assets forming a segregated cover pool pursuant to the applicable provisions of Law 130/1999; ii) the granting of a subordinated loan by the assignor bank or another bank to the assignee in order to finance the acquisition of the assets by the assignee; iii) the provision by the assignee of a guarantee in favour of the bondholders up to the amount of the segregated assets.[1]

Pursuant to paragraph 5 of Article 7-*bis*, a regulation of the Minister for the Economy and Finance shall establish implementing provisions concerning: (a) the maximum ratio between covered bonds and assigned assets; (b) the specification of the type of such assets and those with an equivalent risk profile that may subsequently be used to supplement the assigned assets; (c) the characteristics of the guarantee.

Supervisory regulations governing this area shall be issued pursuant to paragraph 6 of Article 7-*bis* and Article 53 of the 1993 Banking Law, in accordance with the resolutions of the Interministerial Committee for Credit and Savings (the Credit Committee).

These regulations establish the requirements for issuer banks, which shall have a high level of capitalization in view of the specific characteristics of the covered bond market and the need to protect creditors other than the covered bondholders, whose security is reduced as a result of the assignment of the high-quality bank assets.

To protect creditors other than covered bondholders, first and foremost depositors, limits have been established on the assignment of the assets providing priority security for the covered bondholders. Such limits, which shall apply at the consolidated level, are graduated in

[1] The law also permits the issuance of covered bonds using the earmarked assets referred to in Article 2447-*bis* of the Italian Civil Code. For this purpose, under Article 7-*ter* of Law 130/1999, specific implementing regulations shall be issued by the Minister for the Economy and Finance and the banking authorities, pursuant to Article 7-*bis*, paragraphs 5 and 6, respectively, of that law.

relation to the banking group's capital strength (total capital ratio calculated on the basis of supervisory capital and Tier 1 capital).

The prudential treatment of the covered bonds and the subordinated loan shall be governed in accordance with the applicable Community regulatory framework.

With regard to the operational and legal complexity of the transactions, special organizational instructions shall apply to the participating banks. The risks connected with the issue programmes shall be carefully assessed by the competent governing bodies, taking account of the complexity of the transactions and the impact that they have on the bank's financial situation and its internal control system. The regularity of the transactions shall be monitored by the bank and by an independent asset monitor.

2. Legislative sources

The field is governed by:

- Article 22, paragraph 4, of Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS);
- Annex VI, Part 1, points 68 to 71, of Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions;
- Article 19, paragraph 2 of Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions;
- Article 7-*bis* of Law 130 of 30 April 1999, introduced by Law 80 of 14 May 2005;
- the following articles of the 1993 Banking Law:
  - Article 12, which governs bonds and certificates of deposits issued by banks;
  - Article 51, which requires banks to send the Bank of Italy periodic returns, as well as any other figures or documents it may request, in the manner and within the time limits it establishes;
  - Article 52, which governs notifications by boards of auditors and persons appointed to audit the accounts to the Bank of Italy;
  - Article 53, paragraph 1, sub-paragraphs a), b) and d), which give the Bank of Italy, in compliance with the resolutions of the Credit Committee, the power to issue general regulations concerning capital adequacy, the limitation of risk in its various forms, administrative and accounting procedures and internal control mechanisms;
  - Article 53, paragraph 3, which gives the Bank of Italy the power, inter alia, to adopt specific measures regarding individual banks concerning the matters referred to in paragraph 1, where the situation so requires;
  - Article 61, paragraph 5, which establishes that Article 52, which governs notifications by boards of auditors and persons appointed to audit the accounts to the Bank of Italy, shall apply to parent financial companies;

- Article 66, paragraphs 1 and 2, which require parent companies of banking groups to provide information in the manner and within the time limits established by the Bank of Italy;
- Article 67, paragraphs 1, 2-*ter* and 3-*bis*, which, for the purpose of carrying out consolidated supervision, establish that the Bank of Italy, in compliance with the resolutions of the Credit Committee, shall, by way of general or specific regulations, issue instructions to the parent undertaking or to the components of the banking group with regard to capital adequacy, the limitation of risk in its various forms, administrative and accounting procedures and internal control mechanisms;

and in addition:

— Decree 310 of 14 December 2006 of the Minister for the Economy and Finance;

— Credit Committee resolution of 2 August 1996 with regard to administrative and accounting procedures and internal control mechanisms, as amended by the Credit Committee resolution of 23 March 2004;

— the Decree of the Minister for the Economy and Finance as Chairman of the Credit Committee, of 27 December 2006;

— Decree 213 of April 2007 of the Minister for the Economy and Finance as Chairman of the Credit Committee.

3. Definitions

In these regulations:

- "law" shall mean Law 130 of 30 April 1999 as amended;
- "regulation" shall mean Decree 310 of 14 December 2006 of the Minister for the Economy and Finance;
- "covered bonds" shall mean covered bonds issued pursuant to Article 7-*bis* of the law;
- "issuer bank" shall mean the bank that issues covered bonds;
- "assignor bank" shall mean the bank that transfers assets to the assignee pursuant to Article 7-*bis* of the law;
- "lending bank" shall mean the bank that grants the subordinated loan to the assignee;
- "subordinated loan" shall mean the loan granted to the assignee by the assignor bank or by another bank to acquire eligible assets with repayment subordinate to full satisfaction of the covered bondholders and of the counterparties to derivative contracts to hedge risks and ancillary agreements, as well as to payment of other transaction costs;
- "assignee" shall mean the company whose sole purpose, pursuant to Article 7-*bis* of the law, is to acquire loans and securities with financing granted or guaranteed by banks, including the assignor banks, and the granting of guarantees for bonds issued by such banks or other banks;
- "eligible assets" shall mean the assets (loans and securities) specified by the regulation as eligible for transfer to the assignee (see Article 2, paragraphs 1 and 2, and Article 6 of the regulation);

- "supplementary eligible assets" shall mean assets with risk profiles equivalent to those of the eligible assets that under the provisions of the regulation may subsequently be used to supplement the eligible assets (see Article 2, paragraph 3, sub-paragraphs 2 and 3, and paragraph 4 of the regulation);
- "total capital ratio" shall mean the ratio between supervisory capital[2] and the total capital requirement of the bank or banking group[3] multiplied by 12.5;[4]
- "Tier 1 ratio" shall mean the ratio between Tier 1 capital and the total capital requirement of the bank or banking group multiplied by 12.5.[5]

4. Scope of the regulations

The provisions of these regulations shall apply to banks authorized in Italy and parent financial companies of banking groups.

Section II

1. Eligibility requirements for issuer or assignor banks

Banks belonging to banking groups meeting the following requirements at the time of the issuance shall be allowed to issue covered bonds:

- consolidated supervisory capital[6] of at least €500 million; and
- a consolidated total capital ratio of at least 9%.

The requirements shall also be met at the time of the transfer by assignor banks, if they are not the issuer banks and do not belong to the same banking group.[7]

For banks not belonging to a banking group, the requirements shall refer to individual supervisory capital and the individual total capital ratio, respectively.

2. Transfer limits

[2] See Title I, Chapter 2 of Circular 263 of 27 December 2006, "New regulations for the prudential supervision of banks".

[3] See Title II, Chapter 6, of Circular 263. The total capital requirement shall be considered gross of eligible Tier 3 subordinated loans.

[4] Supervisory capital /(total capital requirement * 12.5).

[5] Tier 1 capital /(total capital requirement * 12.5).

[6] See Title I, Chapter 2, of the "New regulations for the prudential supervision of banks".

[7] In case the requirements are no longer met, additional covered bonds cannot be issued even if this had been formally decided and part of the cover pool is still available.

Eligible assets may be assigned subject to the following restrictions, graduated based on the total capital ratio and Tier 1 ratio at the consolidated level:[8]

Capital strength		Transfer limits
Band "a"	Total capital ratio ≥ 11% and Tier 1 ratio ≥ 7%	No limit
Band "b"	Total capital ratio ≥ 10% and < 11% and Tier 1 ratio ≥ 6.5%	Transfer permitted up to 60% of eligible assets
Band "c"	Total capital ratio ≥ 9% and < 10% and Tier 1 ratio ≥ 6%	Transfer permitted up to 25% of eligible assets

The capitalization requirements (total capital ratio and Tier 1 ratio) specified for each band shall be met jointly. Otherwise, the limits specified for the next lower band shall apply.[9] The transfer limits, expressed as a percentage of eligible assets, shall refer to the total for such transactions carried out by a banking group.[10] The limits set out in this paragraph shall apply to the eligible assets held by the Italian entities of the assignor bank's banking group whenever any foreign entities of that banking group have issued covered bonds − thus using part of their assets to collateralize those bonds − pursuant to the respective legislation.

3. Supplementation of transferred assets

The supplementation of transferred assets subsequent to the initial assignment shall be carried out by way of the transfer of additional eligible assets or supplementary eligible assets.[11] Supplementation shall also be permitted beyond the transfer limits referred to in sub-section 2.

Supplementation shall be permitted solely to maintain the ratio between the covered bonds and the transferred assets[12] up to the maximum limit set by the regulation[13] or that established by contract, in the case of overcollateralization, as well as to comply with the 15%

8 In the case of banks not belonging to a banking group, the total capital ratio and Tier 1 ratio shall be calculated at the individual level.

9 For example, a banking group in band "b" for the total capital ratio (i.e., equal to or greater than 10% and less than 11%) and in band "c" for the Tier 1 ratio (i.e., equal to or greater than 6% but less than 6.5%) shall be subject to the restrictions indicated for band "c".

10 Or by a bank that does not belong to a banking group.

11 For the purposes of this sub-section, the transfer of additional eligible assets performed under established programs that provide for the issuance of covered bonds with different maturities or over the course of a specified period of time shall not constitute supplementation.

12 For example, if the total nominal value or the net present value of the assets in the segregated cover pool decreases due to the writedown of the assets themselves.

13 See Article 3 of the regulation.

limit on supplementary eligible assets included in the segregated assets.[14] The option of replacing the supplementary eligible assets included in the segregated assets with eligible assets shall not be affected.

Substitution of eligible assets included in the assignee's segregated cover pool with other assets of the same kind originated by the issuer bank is permitted provided that this is expressly set out in the issuance programme and term sheet, which shall indicate when substitution is allowed, assure an adequate market disclosure and, if necessary, set congruous quantitative limits to substitution.

Contracts entered into by banks in relation to the issuance of covered bonds and the accompanying informational documents shall expressly acknowledge that the supplementation of the transferred assets is not permitted except as provided for in these regulations.

4. Prudential treatment

Purchased covered bonds fall within the portfolio of "exposures in the form of covered bonds" provided for under the standardized approach. Accordingly, such exposures shall qualify for reduced risk weights for the purpose of calculating the capital requirement for credit risk,[15] as well as the risk weights for the purposes of the rules governing concentration risks.[16] Under the same conditions, banks that adopt the foundation IRB approach shall use the LGD values established for covered bonds in the relevant regulatory function.[17]

For market risks, the special methods for calculating the capital requirement for the specific risk on debt securities [18] shall apply to covered bonds.

With regard to the subordinated loan to the assignee, if the loan is granted by the bank that issues the bonds and transfers the assets, the issuer bank shall maintain the same capital requirement for the transferred assets that it was required to meet prior to the transfer ("transferred assets requirement"). The same capital treatment shall apply where the subordinated loan is granted by another bank in the same banking group as the issuer and/or assignor.

In all other cases, the lending bank shall hold a capital requirement equal to the greater of the "transferred assets requirement" and the requirement resulting from the application of the risk weight for the issuer bank and, where different, for the assignor bank on the basis of the method for calculating capital requirements adopted by the lending bank.

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[14] See Article 2, paragraph 4, of the regulation, pursuant to which supplementation with supplementary eligible assets is permitted up to the specific limit of 15% of the value of the assets included in the segregated assets of the assignee.

[15] See Title II, Chapter 1, Part 1, Section V, of the "New regulations for the prudential supervision of banks".

[16] See Title V, Chapter 1, Section III and related Annex A, of the "New regulations for the prudential supervision of banks".

[17] See Title II, Chapter 1, Part 2, Section V, sub-section 1.2, of the "New regulations for the prudential supervision of banks".

[18] See Title II, Chapter 4, Part 2, Section II, sub-section 2.2.1, of the "New regulations for the prudential supervision of banks".

5. Responsibility and controls[19]

The operational framework envisaged for the issuance of covered bonds involves the entry of the issuer bank and, if different, the assignor bank into a new market characterized by a high degree of operational and legal innovation and complexity. Significant aspects include: the ring-fencing of high-quality assets, which gives the covered bondholders a priority claim on such assets; the assumption of an obligation to monitor the quality and the value of the transferred assets and, if necessary, to supplement such assets to maintain the value of the collateral securing the transaction; the structure of the contractual relationships between the assignor bank, issuer bank, lending bank and the assignee; the need to provide adequate disclosure to bondholders; and reporting to the Bank of Italy. With regard to the complexity of the contractual aspects and the possible impact on the banks' financial situation, decisions regarding participation in individual transactions or issue programmes[20] – as issuer of the bonds and assignor of the assets – shall be preceded by the identification and careful assessment of the objectives pursued and the related risks, including legal and reputational risk, as well as the establishment of adequate control procedures, by the management body. Such assessments and procedures shall be approved by the bank's supervisory body and submitted to the control body for an opinion concerning the compliance of the transaction or the activities described in the programme with the law, the regulation and these provisions, as well as the impact of the activity on the bank's financial position and performance.

The same assessments shall be carried out by the bodies of the parent company of the issuer and assignor banks, also taking account of the transaction's consistency with the strategies of the group as a whole, its compatibility with the operational equilibrium of the individual components of the group and the adequacy of the internal control system at the group level.

To support the resolutions concerning the assignment of assets, both at the start of a transaction and in the subsequent supplementary transfers, the assignor bank requests an auditing firm[21] to certify that its verifications have found nothing indicating that the valuation criteria used to set the assets transfer price are different from those applicable to the assignor bank in the preparation of its financial statements. Such certification is not required if the transfer is carried out at the carrying amounts reported in the most recent annual financial statements approved by the assignor bank with no remarks from the auditing firm. The certification is also not necessary whenever any gaps between the carrying amount reported in the financial statements and the transfer price depend exclusively on the ordinary financial dynamics of the transferred assets and do not relate in any way to qualitative changes of the

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[19] With regard to the identification of the supervisory, management and control bodies referred to in this sub-section, see Title I, Chapter 1, Part 4 of the "New regulations for the prudential supervision of banks".

[20] For this purpose "issue programmes" are programmes of activities regarding the issue of covered bonds over a given period of time, including programmes spanning more than one year, and the related transfers of eligible assets, in which the expected volumes and characteristics of the instruments and the contracts are identified in sufficient detail to enable a complete, informed assessment: i) of the impact of the activity on the financial position and performance of the bank and the group during the reference period; ii) of the different types of risk connected with the individual transactions carried out to implement the programme.

[21] The auditing firm shall be entered in the special list maintained by CONSOB pursuant to Article 161 of the Consolidated Law on Financial Intermediation; it can be the same firm auditing the issuer bank's financial statements.

assets and/or the assigned debtors creditworthiness.

The management body shall ensure that the risk management structures of the issuer bank or the related banking group verify at least once every six months and for each transaction:

- the quality and integrity of the transferred assets collateralizing the bonds. Specifically, the estimate of the market value of the residential or non-residential property encumbered by mortgages relating to the assigned real estate loans and mortgage loans shall be performed in accordance with the procedures and with the frequency established in the regulations concerning the calculation of capital requirements for credit risks;[22]
- compliance with the maximum ratio between the covered bonds issued and the transferred cover assets;[23]
- compliance with the transfer limits and procedures for additional supplementary transfers referred to in subsections 2 and 3 above;[24]
- the effectiveness and adequacy of the risk protection provided by any derivative contracts used to hedge the transaction.

The monitoring of the regularity of the transaction and of the integrity of the collateral securing investors shall also be conducted by an external party (the “asset monitor”) engaged by the issuer bank. The asset monitor shall be an auditing firm[25] possessing the professional skills required to perform such duties and shall be independent of the bank engaging it and of the other persons participating in the transaction. Independence shall mean non-coincidence of the auditing firm responsible for asset monitoring with the auditors of the issuer bank or of the other parties in the transaction (the assignor bank, if different from the issuer, and the assignee). Independence is not affected if the asset monitor is the auditor of other entities of the banking group not involved in the transaction as issuer or assignor.

In order to prevent duplications of controls, terms and conditions of monitoring can be structured as verifications by the auditing firm on the controls carried out by the issuer bank according to agreed upon procedures. The asset monitor shall check the regularity of transactions and the integrity of collateral according to proportionality, extending the scope of verifications and increasing their frequency if the situation of markets or of the issuer may impact on the transaction’s regularity or the investors’ protection. Within this framework, direct statistical checks proportionate to the transaction’s characteristics and risks shall be carried out.

The asset monitor shall prepare an annual report also to the control body of the bank that has engaged it on the checks performed and their results. The requirements established by Articles 52 and 61, paragraph 5, of the 1993 Banking Law for persons that perform control

[22] See Title II, Chapter 1, Part 1, Section IV, of the “New regulations for the prudential supervision of banks”.

[23] See Article 3 of the regulation.

[24] Monitoring of compliance with the transfer limits shall also be performed by the internal control structures of the assignor bank or the related banking group if different from the issuer bank or banking group.

[25] See Article 7-*bis*, paragraph 6, of the law. The firm shall be entered in the special list maintained by CONSOB pursuant to Article 161 of the Consolidated Law on Financial Intermediation and shall be independent of the entity appointed to audit the accounts of the issuer bank.

functions shall apply.[26]

The internal audit function of the issuer bank or the related banking group shall perform a full audit of the checks performed at least once a year, making use where necessary of the information provided and conclusions expressed by the asset monitor. The findings of such audits shall be reported to the governing bodies.

The management bodies of the issuer banks or banking groups shall ensure that an assessment of the legal aspects of covered bond transactions is performed on the basis of specific reports by experts containing an in-depth examination of the structures and contractual forms used, with a special focus on the status of the guarantee granted by the assignee and on the overall set of relationships between the issuer bank, the assignor bank, the lending bank and the assignee.

Issuer banks and banking groups shall also conduct a careful assessment of the organizational and management arrangements of the assignee, which shall be appropriate to the duties for which the latter is responsible. Contracts entered into by the banks regarding the transaction shall contain clauses that ensure the regular and efficient performance of the functions by the assignee.

In order to ensure that the assignee is capable of meeting its obligations in respect of the guarantees in an orderly and timely manner, issuer banks shall use appropriate asset and liability management techniques, including by way of specific checks performed at least every six months, to ensure the overall maturity matching of cash flows generated by the transferred assets in the segregated asset pool held by the assignee and the payments due from the issuer bank in respect of the covered bonds and other costs of the transaction.[27]

With regard to disclosure, the participants in the transactions shall enter into contractual undertakings that grant the issuer bank and the assignor bank – as well as any other person engaged to perform service activities for the transferred assets – access to the information on title to and developments in the transferred positions needed to perform the checks envisaged in this section, as well as to comply with supervisory reporting requirements, including those associated with participation in the Central Credit Register service.

Rome, 24 March 2010

THE DIRECTOR GENERAL
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[26] See Title IV, Chapter 11, Section IV, sub-section. 1.3, of the "*Istruzioni di Vigilanza per le banche*".

[27] In this regard, it should be noted that pursuant to Article 3 of the regulation, assets included in the segregated asset pool securing the transaction must generate interest in an amount at least equal to the interest owed by the issuer bank on the covered bonds, taking account of any derivative contracts hedging the financial risks entered into as part of the transaction.