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New measures for speeding up credit recovery: an initial analysis of Decree Law 59/2016

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Summary

Decree Law 59/2016, converted into law at the end of June, contains new measures for reducing credit recovery times, following on from the measures adopted in 2015. It introduces new mechanisms to ensure more effective protection of entities that grant loans to firms, envisages information tools to assist participants in the non-performing loan (NPL) market and amends the regulations governing judicial recovery proceedings. Overall, the new measures promote a more effective management of NPLs by banks. They will further reduce average NPL recovery times, positively impacting the value of these assets and the development of the NPL market. Taken as a whole, the measures will ultimately translate into better lending conditions and more opportunities for firms and households to obtain financing.

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Introduction and main conclusions

In the summer of 2015 a reform of the procedural and bankruptcy laws was launched to improve the process for recovering non-performing loans, reducing the length of proceedings and improving recovery rates.¹⁾

Decree Law 59/2016, converted into law at the end of June, addresses the same subject matter and follows on from the previous reform.²⁾ It introduces new mechanisms to ensure more effective protection of persons and entities that grant loans to firms, envisages information tools to assist NPL market participants, and amends the regulations governing judicial recovery proceedings. Overall, the new measures promote a more effective management of NPLs by banks.

They will further reduce average NPL recovery times, which will have a positive impact on the value of these assets and on the development of the NPL market. Taken as a whole, the measures will ultimately translate into better lending conditions and more opportunities for firms and households to obtain financing.

In the short term, the change that is expected to have the greatest impact is the permitted inclusion in loan agreements of clauses for the out-of-court enforcement of real property guarantees (the Marcian Pact, see Section 1.b). If recourse to these measures were to become widespread, a reduction in recovery times to just six months would significantly raise the market prices for new bad loans to near their book values. The effects on the average market price of the stock of existing bad loans would be more limited, but nonetheless positive: in fact, in this case, the impact of the measures would depend upon the percentage of loan agreements actually renegotiated to include the new enforcement procedures (see Section 5).

Overall, the 2015 and 2016 reforms have significantly improved the regulatory framework for managing NPLs, introducing targeted measures to reduce recovery times and improve recovery rates. Changes have been introduced to encourage the use of negotiated crisis management instruments and improve their effectiveness. The system will also benefit from more widespread use of digital tools to conduct proceedings and the greater transparency ensured by instruments such as the single sales portal and the proceedings register.

Further efficiency gains could be made by developing a specialized bankruptcy court system and, where necessary, reinforcing court staff, in keeping with the principles set out in the Rordorf Bill currently before Parliament.

1) Decree Law 83/2016, converted as amended into Law 132/2016. For a description of the measure and an assessment of its effects see M. Marcucci, A. Pischedda and V. Profeta, 'The changes of the Italian insolvency and foreclosure regulation adopted in 2015', Banca d'Italia, *Notes on Financial Stability and Supervision*, No. 2, 2015.

2) Decree Law 59/2016, converted as amended into Law 119/2016.

The guarantee system is broadened with the addition of two new mechanisms

A non-possessory security interest is introduced ...

... which can be enforced out-of-court in a variety of ways

The Marcian Pact is introduced for loans to firms guaranteed by real property

1. Changes to the guarantee system

Decree Law 59/2016 has broadened the range of guarantee instruments by adding two new mechanisms that seek to strengthen the system for protecting entities that grant loans to firms and, in this way, ensure the availability of credit. In parallel with this, the decree law has established special protections for borrowers affected by the application of these mechanisms.³⁾

a. Non-possessory pledge

A non-possessory security interest was introduced into the Italian legal system enabling debtor-entrepreneurs to pledge (including through third party guarantors) a vast array of assets (including future or yet unspecified assets) without having to transfer control of them as is required with a traditional pledge. To inform interested parties of the existence of the lien an online register will be set up by the Revenue Agency.⁴⁾ The new measure thus brings Italy's system into line with those of other major advanced economies.⁵⁾

The non-possessory pledge can be enforced in a variety of ways as an alternative to judicial action. The creditor can sell the asset via a competitive bidding process, including through specialized operators, on the basis of an expert's appraisal⁶⁾ or it can move to collect the amount owed in the case of a non-possessory pledge against credits. If provided by the contract, the asset may be leased and the lease instalments counted towards repayment of the debt or the pledged asset can be seized, up to the amount guaranteed.

To avoid any doubt as to its application, the decree law sets out specific provisions on challenging the collection process, on enforcing the pledge, and on coupling credit recovery procedures with other enforcement measures.

b. Transfer of real property as guarantee (Marcian Pact)

For loans granted to firms, the new law makes it possible to include in loan agreements a specific provision that, should the debtor commit a material breach,⁷⁾ gives the creditor (bank or other authorized intermediary) the right to obtain ownership, through an out-of-court proceeding, of real property serving as guarantee, providing this is not the primary residence of the debtor in breach or of his/her relatives (or of a third party guarantor). The result is therefore different from that of the enforcement procedure in which the creditor usually receives the cash amount obtained from the sale of the pledged assets. The transfer can also regard property rights other than ownership.

3) See E. Brodi, 'Il sistema delle garanzie in Italia: una lettura economica delle disposizioni in materia di privilegio, pegno e ipoteca', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

4) The register will become fully operational after a decree is adopted by the Ministry of Economy and Finance together with the Ministry of Justice, within 30 days of the entry into force of the law converting the decree (3 July 2016).

5) See World Bank, *Doing Business 2016*, available at <http://www.doingbusiness.org>, and E. Brodi, op. cit. (note 3).

6) In the event of an out-of-court sale – apart from assets whose value cannot be ascertained – the sale price is set by an expert, appointed with the consent of both parties or, where no consensus has been reached, the court.

7) This refers to the failure to make payment on at least three instalments, including non-consecutive instalments, for a period of nine months or more from the due date in the case of monthly instalments, or for a period of nine months or more from the due date of even one instalment in the case of less frequent instalment payments or of loans to be repaid in a lump sum. Furthermore, if the debtor has repaid at least 85 per cent of the loan principal, the default period is increased from nine to twelve months.

The enforcement procedure consists of the following steps: notifying the debtor (or the third party guarantor) of the intention to obtain ownership of the property and indicating the amount of the credit pursued; requesting that the Head of the Court appoint an independent expert to appraise the value of the property; the preparation of the estimate by the expert; and in the event that the estimated value is higher than the amount of the outstanding loan, paying any difference to the debtor. The appraisal must be made on the basis of the market value, in accordance with the criteria established for valuing real property in the foreclosure procedure;⁸⁾ this ensures that appraisals are standardized and clarifies ex ante the criteria to be used by the experts, providing benefits in terms of impartiality and transparency. The debtor may challenge the appraised value; however, this challenge does not suspend the transfer of ownership but, if upheld, only affects the monetary difference that the creditor is required to pay. After having notified the debtor of the intention to activate the clause, the creditor must wait 60 days before requesting that the court appoint the expert, who must make the appraisal within 60 days.⁹⁾ There is no indication, however, of any deadline by which the court must appoint the expert.

The Marcian Pact significantly reduces credit recovery times ...

... and can also be applied to existing loans through renegotiation

It is reasonable to assume that, with the Marcian Pact, the time period for the transfer of real property will be reduced to six months, where the estimated average duration of judicial foreclosure proceedings was more than four years prior to last summer's measures and more than three years prior to Decree 59/2016.

The Marcian Pact can be incorporated at the time the loan agreement is signed or can be introduced later on by renegotiating the contractual terms. Therefore, it can also be applied to the stock of NPLs, provided that no insolvency proceedings have been initiated.

In the case of default by the debtor, the pact can be employed even if the pledged asset is subject to foreclosure. In this case, it is the court enforcing the clause that determines whether default has occurred and the expert appointed by the court who determines the estimated value.

2. Register of bankruptcy and enforcement proceedings

The register will augment the amount of information available to NPL market operators

A digital register will be created with information on judicial property foreclosures and insolvency proceedings (bankruptcy, special administration, arrangements with creditors, restructuring agreements and recovery plans). The register is modelled after the Public Access to Court Electronic Records ('PACER') database in the US, through which market operators of NPLs (funds and investment banks, financial consultants, law offices and others) acquire detailed information on American court cases.

The register will be administered by the Ministry of Justice and the Bank of Italy will be permitted to utilize the information it contains for its own institutional purposes. The

8) More specifically, the expert makes an estimate by calculating the surface area of the real property, the value per square metre and the overall value, making individualized adjustments and corrections to the estimate.

9) This time period was introduced by the law converting the decree, which also called for a 20-day period in which a meeting can be held between the expert, creditor and debtor (or third party guarantor), for any revision of the appraisal or for clarification in the event of a challenge.

register will be divided into two sections: one will be open to the general public (free) while the other will have restricted (normally fee-paying) access reserved for specific categories of interested parties.¹⁰⁾ The greater transparency afforded by the availability of this information can make the valuation of NPLs easier and contribute to the development of the NPL market. It may also make restructuring easier by favouring bulk purchases of NPLs from individual companies in distress, in order to acquire control over the restructuring plan ('loan to own' transactions).

3. Changes to the rules governing enforcement proceedings

The decree law sets out measures – in addition to those introduced in 2015 – that accelerate judicial property foreclosure proceedings, streamline the procedures, and improve the probability of selling pledged assets, thereby increasing recovery rates. The decree law envisages:

- a) making it mandatory for courts to use digital tools in sales transactions (their use was discretionary until now). This will contribute to widening the pool of potential purchasers;
- b) giving potential purchasers the right to examine the assets for sale within fifteen days of the request via a portal for public sales;
- c) allowing the sale price to be lowered by up to 50 per cent after the fourth unsuccessful attempt at sale.¹¹⁾ The purpose of this is to avoid multiple fruitless attempts at sale and to hasten the conclusion of the enforcement process;
- d) increasing the options for directly assigning the asset to creditors. The assignment mechanism, already overhauled by the 2015 reform, has now been strengthened by permitting creditors to submit requests for assignment at the base price used in the last unsuccessful attempt at sale, including in favour of a third party to be named within five days. The provision can facilitate the acquisition of pledged real property by creditor banks with a view to transferring it to real estate management firms;
- e) making it easier for the custodians appointed by the court to release pledged real property without the formalities envisaged by the Civil Procedure Code for the release of property (in particular, without the assistance of the judicial official);
- f) barring the challenging of an enforcement by the debtors beyond a certain period of time. For proceedings begun following the entry into force of the reform, once the court authorizes the sale or the assignment of the pledged real property, the debtor can no longer challenge the enforcement proceeding, except in cases in which there are new material events or delays that are no fault of the debtor;

10) The regulations have the dual task of identifying the categories of entities permitted to consult the restricted section of the register and the fee to be charged for such access.

11) With the changes introduced by Decree Law 83/2015, after the first unsuccessful sale attempt, the judge can lower the sale price by one fourth with respect to the previous one; at the third and fourth attempts the price can be lowered by a further 25 per cent; at the fifth attempt it can be lowered by up to a maximum of 50 per cent.

- g) permitting a partial distribution of the proceeds of the enforcement proceeding, so as to speed up slightly the satisfaction of creditors' claims; the partial distribution plan can cover up to 90 per cent of the amount to be distributed;
- h) providing an official list of the professionals that oversee the sale of the pledged assets as mandated by the judge presiding over the enforcement proceeding.

The measures aim to increase market interest in the asset and improve sale conditions. A process that is more rapid, straightforward and streamlined will produce benefits for both creditors and debtors.

4. Amendments to the Bankruptcy Law

The decree law simplifies bankruptcy proceedings and introduces specific measures to reduce their duration. In particular, it introduces the revocation of the administrator's appointment in the case of delay in distributing the sums recovered, so as to speed up even partial recovery by creditors. Moreover, the administrator may access databases containing information on debtors' positions. Lastly, it streamlines the procedures for meetings of creditors, which can be conducted electronically.

5. Effects of the Marcian Pact on the market valuations of non-performing loans

The new measures will contribute to significantly reducing the duration of recovery proceedings. In the short term, as mentioned above, the most notable impact is expected to come from the Marcian Pact, applicable to commercial loans, which allows for a marked reduction in the time needed to enforce a guarantee in the event of a debtor's non-performance.

The reduction in credit recovery times may affect new loans, issued via contracts that take the pact into account, and existing NPLs so long as the parties consent to the necessary contractual amendments. All else being equal, this will translate into an increase in the market value and price of NPLs.¹²⁾

The Marcian Pact's estimated impact can only be calculated with reference to commercial bad loans secured by real estate. Using the methodology detailed by Ciavoliello et al (2016) two simulations were conducted. In the first, the impact of the introduction of the Marcian Pact on the price of future bad loans was estimated (regime impact); in the second, the effect on the average price of the stock of existing bad loans was estimated (transition phase impact), under the assumption that some existing contracts would be renegotiated to trigger the Marcian Pact.¹³⁾

12) L.G. Ciavoliello, F Ciocchetta, EM. Conti, I. Guida, A. Rendina and G. Santini, 'What's the value of NPLs?', *Notes on Financial Stability and Supervision*, No. 3, 2016.

13) It is assumed that the Marcian Pact is applied to the same real property that secured the loan at its issuance.

The Marcian Pact will increase the market price of bad loans

When fully operational, the market price of bad commercial loans secured by real estate could reach as high as their book value

The increase in the average price of the stock of existing bad commercial loans will depend on the number of contracts actually renegotiated

When fully operational, should the inclusion of the Marcian Pact in contracts become standard practice, its effect on the market price of bad commercial loans secured by real estate will be considerable. Assuming a recovery time of six months on account of the reform, the price a market operator would be willing to pay for a bad loan with an initial gross value of 100 and a current book value of 60 could reach as high as the book value.¹⁴⁾

In the transition phase, the quantification of the effect on the average price of the stock of existing bad commercial loans secured by real estate will depend on (a) the number of commercial bad debts potentially eligible for the out-of-court procedure and (b) the percentage of these loans that will actually be renegotiated.

With regard to point (a), we can assume that the positions that could potentially be eligible for the mechanism are those recently classified as bad loans for which judicial recovery proceedings have not begun or are still in the early stages. Taking into account those classified as bad debts for less than two years, the amount would be equal to a third of commercial bad loans secured by real property. With regard to point (b), the renegotiation of a loan depends on the incentives of banks and firms, which in turn are influenced by the specific characteristics of each credit facility. If this percentage were 50 per cent, the average difference between the book value and the price offered by investors for the entire stock of commercial bad loans secured by real estate would fall by about 15 per cent. This would correspond to an increase in the average price offered by investors for these bad loans, expressed as a proportion of the initial gross value of around 5 percentage points.¹⁵⁾

14) The exercise reported makes reference to the case of a bad loan secured by real property, which on average in the Italian banking system is assessed at about 60 per cent of its initial gross value (hence the estimated 60). The calculations reported in the cited work are instead in reference to a bad debt only partly secured by collateral which on average is valued at 40 per cent of its initial gross value.

15) Unlike the 'regime impact' estimate, in the second estimate, beyond the 6 months needed to conclude the out-of-court forfeiture proceeding, an additional 9 months were factored in as a prerequisite for enforcement (for a total of 15 months). It was assumed that, following a renegotiation, the debtor must again fail to perform before the creditor can request the transfer of the property (see note 7).