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New Tier 1 capital rules for Italian banks

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Further to changes made to the Italian Banking Act (*Testo Unico Bancario*) by law-decree No. 297 approved by the Italian Government as a matter of urgency on December 22, 2006 (the law-decree still needs to be ratified into law by the Italian Parliament in order for its effects to become permanent) and the guidelines provided by Treasury Decree No. 933 of December 27, 2006, the Bank of Italy issued on December 27, 2006 a regulation (No. 263) containing the "New Rules on Banking Prudential Supervision" (the "New Regulation").

Such new rules introduce changes to the previous regulatory regime based on a number of factors, including: (i) changes in the international regulatory framework; (ii) the entry into force of the new IAS/IFRS accounting principles; and (iii) consolidated market practices. The main set of provisions that changed the international regulatory framework and which are implemented by the New Regulation are the New Basel Accord approved in June 2006 and EU Directives 2006/48/EC and 2006/49/EC (the so-called "Capital Requirements Directive", which introduced an updated supervisory framework in the EU reflecting the Basel II rules on capital standards).

Among other things, the New Regulation repeals Title IV, Chapter 1 of the Bank of Italy's guidelines for banks (the "Guidelines") governing the regulatory capital (*patrimonio di vigilanza*) of Italian banks.

Title I, Chapter 2 of the New Regulation provides for new rules governing (i) the structure of individual and consolidated regulatory capital, (ii) the items to be included or deducted and (iii) the features of the instruments that can be included in a bank's regulatory capital.

Notably, certain new provisions governing the issue and computation of Tier 1 securities may represent an important tool for a novel capital management of Italian banks.

First, pursuant to the New Regulation, hybrid instruments may now represent up to 20% of a bank Tier 1 capital (to be calculated taking into account these instruments). However, in addition to increasing the general threshold for hybrid instruments - previously set at 15% - the Bank of Italy introduced a distinction between instruments including a redemption incentive (*e.g.*, interest step up), and those that do not (so-called innovative and non-innovative instruments, respectively). Unlike the Guidelines, which only provided for a general 15% basket for any kind of hybrid instrument regardless of their innovative or non-innovative features, the New Regulation states that innovative instruments may represent up to 15% of a bank Tier 1 capital. This means that, in order to take full advantage of the new 20% general threshold, banks will need to issue non-innovative instruments (either in addition to or in lieu of innovative instruments).

Second, the New Regulation appears to offer the possibility for Italian banks to issue Tier 1 instruments directly. Under the Guidelines, it was only possible for Italian banks to issue Tier 1 instruments through a foreign vehicle (typically, a Delaware LLC), which then on-lent the proceeds of the issuance to the Italian parent bank (the so-called "indirect issue"). The opening of the new possibility for Italian banks to effect direct issues is suggested by (i) the deletion, in the New Regulation, of the reference previously contained in the Guidelines to the "indirect foreign subsidiary" through which preference shares had to be issued and (ii) the inclusion in the New Regulation (Title I, Chapter II, Section II, Paragraph 3, letter h)) of a new wording concerning the on-lending agreements reading "if the issue is made through a foreign subsidiary, a specific agreement transferring to the bank the proceeds upon terms equivalent to those of the issue be in place. [...]" which clearly suggests that the indirect issue structure is only an option.[1]

From a tax angle, changes to statutory rules enacted in 2004 have overcome one of the main hurdles relating to direct Tier 1 structures: perpetual debt is now deductible at the issuer's level, even if paid on financial instruments, such as Tier 1 securities, featuring, *inter alia*, a freeze on interest payments in case the issuer's Tier 1 capital should not meet the regulatory ratio set from time to time.

The other issue favoring indirect issuances pertained to the characterization of the securities, it being uncertain whether they should be treated as bond-like, generally taxed at 12.5%, or atypical securities, generally taxed at 27%. As this rate difference should be eliminated by a comprehensive reform of financial income announced by the government

[1] A reference to the indirect issue structure remains in the New Regulation (Title I, Chapter II, Section II, Paragraph 3, letter d)) where, with respect to interest deferral and non-cumulative interest, it is stated that "the agreement must make reference to the possibility not to pay interest to the holders of the securities if, in the previous financial year, *the bank which directly or indirectly controls the issuer* did not have distributable profits and/or did not pay a dividend to its shareholders". However, this reference to the indirect issue is probably an oversight.

and expected to be enacted as early as the summer, which should level all financial income tax rates to 20%, this second issue may also be overcome, at least vis-à-vis Italian investors. The instrument’s characterization, however, would still have a significant impact on foreign investors, as they could access a withholding tax exemption regime only if the securities were characterized as bond-like securities. The characterization will largely depend on the loss absorption mechanism adopted: on a preliminary basis, it could be argued that, insofar as the investor is always entitled to receive at maturity the principal amount invested, the instrument should be characterized as a bond-like security.

Third, under the New Regulation, the term by which the Bank of Italy must grant or deny its authorization to the inclusion of the proceedings deriving from the issue of the hybrid instruments in the Tier 1 capital of the applicant bank has been extended from 60 to 120 days.

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