Wiley Finance Series

Property Finance

An International Approach

GIACOMO MORRI
ANTONIO MAZZA
Country reports edited by Alessandro P. Scarso

WILEY

Table of Contents

www.morri-mazza.com

www.morri-mazza.com

www.morri-mazza.com

Foreword

I'm very honoured to be invited by the authors and by Prof. Alessandro P. Scarso to write a foreword for the thoughtful book *Property Finance – An International Approach*.

As I had the privilege to be the first reader of this book, I believe it to be the most practical and concise guidebook on property finance. Based on the introduction to the fundamentals of property finance, the authors have explored the cutting edge issues of structured real estate financing, loan agreement, bullet payments, effects of financial leverage on real estate investments, structured real estate financing case studies, hybrid forms of financing, the Basel Accords, and effects on real estate financing. This book has a distinctive feature of question and case orientation.

This book has not followed the writing style of the classic textbook. Quite the contrary – the authors present the legal issues first, and then concentrate on providing feasible legal solutions to complete the property financing transactions from various perspectives. Therefore, this book is very appealing to bankers, lawyers, and business people as well as the students of law schools and business schools, who want to gain a clear picture of the legal system on property finance within a short time.

The devil is in the detail. In addition to offering various tailor-made alternatives to meet the different purposes of property financing transactions, this book has also paid appropriate attention to the legal details, which are easily ignored in commercial practice. For instance, the due diligence process, especially legal due diligence, is carefully elaborated on in this book, as most of the failures of property financing transactions could be traced back to the failure of due diligence.

This book is a reader-friendly work in terms of its useful reader's manual and the selection of some of the major jurisdictions on property finance in the seven country reports. These country reports represent not only the developing countries and the developed countries, but also the civil law system and the common law system. The comparative research on property finance in different jurisdictions is extremely important in the era of globalization, as any transaction of property finance could trigger legal effects on the international participants or on the property located in another jurisdiction. This book has successfully pointed out the key differences of property finance systems in different countries. Of course, the authors also encourage readers to identify the commonalities from the various jurisdictions by offering a uniform questionnaire applicable to the seven jurisdictions.

As a Chinese business law scholar, I'm more than pleased to find that Chinese legal rules on property financing have been introduced very accurately. It is true that China has developed a set of sophisticated principles and institutional arrangements on property financing based on its own market conditions and the best international practices. In addition to the statutes

www.morri-mazza.com

such as the Property Right Law of 2007 and Security Law of 1995, the judicial interpretations of the Chinese Supreme Court have also played significant roles in clarifying the ambiguous legal articles.

Of course, it is an open question whether Chinese law recognizes the independent security. In the answer to Question 3 of the country report of China, it is said that “Chinese law so far still does not acknowledge independent security, meaning any type of security, even after establishment, is dependent on the main debt, i.e. the loan contract”. To my knowledge, Chinese courts do recognize the independent security established in the international business transactions, on the ground of the exceptional sentence in Article 5 of the Chinese Security Law, “A guarantee contract is an accessory contract to a principal contract. If the principal contract is invalid, the guarantee contract shall be invalid. Where the guarantee contract stipulates otherwise, such stipulations shall apply.” In 2013, I was invited to offer legal opinions to the Chinese Supreme Court on the possibility of recognizing the independent security in domestic business transactions in the draft of judicial interpretation on independent security. I strongly support the use of independent security in domestic business transactions.

Last but not least, I’m very grateful for the hard work of the prominent authors. When I have to choose a book among hundreds of competing works on the same topic in the bookstores, I usually pay more attention to the reputation and the background of the authors. Giacomo Morri, Antonio Mazza and, as far as the editing of the country reports is concerned, Alessandro P. Scarso completed this book not only on the basis of many years of teaching and research, but also on the basis of their rich experience in the practice of property finance. As a Chinese legal scholar, I personally have benefited greatly from reading it. I’d like to take this opportunity to encourage Chinese and other international readers to share the valuable knowledge presented here.

Beijing, August 2014

Prof. Dr. Junhai Liu
Director, Business Law Center, Law School, Renmin University of China (RUC)
Vice Chairman, China Consumers’ Association
Vice Chairman & Secretary General, China Consumers’ Protection Law Society
Panelist, CIETAC, BAC, HKIAC, VIAC, ICDR/AAA, WIPO, KCAB, APRAG, KLRCA

Foreword

Real Estate plays a vital role in the economy. The findings of research commissioned by EPRA and INREV which evaluates the role and importance of commercial real estate in the European economy indicate that real estate in all its forms accounts for nearly 20% of economic activity. The commercial property sector alone directly contributed €285 billion to the European economy in 2011, about 2.5% of the total economy and more than both the European automotive industry and telecommunications sector combined. It directly employs over four million people, which is not only more than the car industry and the telecommunications sector, but also greater than banking. Investment in new commercial property buildings and the refurbishment and development of existing buildings on average totals nearly €250 billion each year – representing over 10% of total investment in the European economy and equivalent to the GDP of Denmark. The long-term cash flows generated from property investment provide an important source of diversified income in the portfolios of European savers and pensioners. Property in its various forms represents €715 billion – over 6% – of European pension funds and insurance companies' total investments. Direct ownership is their most common form of property investment but indirect forms of investment – either through non-listed funds or listed property companies and REITs – are becomingly increasingly important.

Relative to its importance, real estate remains under researched whilst at the same time real estate education on an undergraduate as well as a postgraduate level falls behind other sectors with regards to number and quality of educational offerings. It is surprising to note that despite the importance of capital structuring decisions the understanding of market participants remains limited on the way in which the multitude of possible structuring choices of varying equity and debt pieces influences real estate investment risk. The effects of the Global Financial Crisis and the subsequent rapid move from an abundance of lenders – be it in the form of banks, insurance corporations, and other financial intermediaries, willing to provide significant amounts of capital – to a marked unwillingness to continue to provide the previous levels of debt in combination with complete withdrawal of some players from global debt markets, together with increasing requirements of lenders with regards to covenants and margins, have started a painful learning process within the real estate industry across all market participants. As the drying up of the debt market has demonstrated, debt and equity markets are in a very dynamic continuously changing mode and are constantly evolving to meet the requirements of borrowers, lenders, and equity investors.

Antonio Mazza and Giacomo Morri, the authors of this book on property finance, solve the perceived dichotomy between real estate practitioners and academia in an ideal way. Mazza and Morri provide a unique property finance textbook that is based on robust economic and finance principles and comparable to those in the area of managerial finance. The structure

www.morri-mazza.com

of the book fulfils the needs of all actors involved in property finance decision making processes as well as those of students in masters programmes with a specific interest in the field of real estate. The book follows a traditional approach by first differentiating and explaining the basics of general financing decisions as a framework and then quickly relates to real estate financing practices in the leading western economies as well as China and India. What makes this book so valuable and distinctive is the seamless blending of theory and practice. The foundation on theory allows an understanding of the real estate capital markets, its institutions, regulations, and structures and the practical examples, calculations, and reference to case studies position this book in an exceptional way.

I do hope that this book will be picked up by its target readership and thus improve the level of knowledge and professionalism in property finance.

Amsterdam – Brussels, August 2014

Prof. Dr. Matthias Thomas
Chief Executive Officer, INREV (European Association for Investors in Non-Listed Real Estate Vehicles)

Preface

The Global Financial Crisis (GFC) has confirmed the importance of proper and accurate finance models in the property market. Since then, a period of deep change has commenced, with new structures, characteristics, and perspectives in the property market arising. Moreover, the change also extends to the property market's relationships with other sectors, primarily capital markets and banking. The GFC which has engulfed the world's largest markets has revealed, amongst other things, one common element: players with a global presence will be in a better position to overcome local crises as they can offset cyclical recessions in certain countries against growth periods in others. A global presence enables companies to recoup losses incurred in the developed markets with profits from emerging countries. With this end in view, international investors build up real estate portfolios through the acquisition of properties located around the world in order to allocate the risk among different markets.

The same dynamic is at work in the real estate finance sector. Financial institutions specializing in granting commercial real estate loans have for some time appreciated that the globalization of their reference market represents a major opportunity, as it enables them to finance the property market throughout the world, thereby preventing a real estate crisis or recession in any individual country from causing them to default. This approach is also appreciated by all stakeholders of these financial institutions including shareholders and the holders of covered bonds, which are often used as a source of real estate finance.

The aim of this book is to describe and present factors common to any structured real estate finance irrespective of where it is to take place. These factors may be global or local in reach.

The global factors relate to the technical, economic, legal, and financial variables which must be analysed by operators when engaging in an operation to finance the purchase of property anywhere in the world. These involve economic and financial issues (the substance of the finance), as well as legal considerations (the form of the finance).

Amongst other topics, Part One addresses issues relating to the processing of real estate operations by banks and financial institutions, negotiations relating to structured property finance, the drafting of term sheets and the insertion of covenants, as well as guarantees usually requested by financial institutions. Part One is supplemented by various forms of practical support, such as examples and financial models which illustrate problem areas and set out the principal operational and technical instruments.

Any structured finance operation however is inconceivable without taking into account local factors concerning the investment object – the property – and hence the assessments which local market experts must make in order to establish its value and return. Needless to

www.morri-mazza.com

say, such factors involve, *inter alia*, civil law and tax and town planning legislation in force in the country in which the property to be financed is located. In particular, in relation to real estate finance, the statutory framework regulating guarantees under loan agreements and the procedural rules governing the terms on the enforcement of personal and real guarantees are of utmost significance.

It is precisely for this reason that Part Two of the book sets out the peculiarities of seven among the most important legal systems by asking questions of relevance to leading domestic lawyers specializing in real estate finance. The reader can thus consider the problems relating to any given jurisdiction in greater depth and compare and contrast the positions under different legal systems.

Such a twin-track approach is extremely practical and detailed on the one hand, whilst adopting a bird's eye view on the other, thereby aiding readers to quickly grasp the key areas of structured financing in the real estate sector, whilst enabling from the outset the most important operational instruments commonly used around the globe to be understood and, above all, put to use.

It is our hope that this book will contribute to a better understanding of the fascinating world of property finance.

San Clemente – Chia, July 2014

Giacomo Morri, Antonio Mazza

Preface to Part Two

The core skills required in the field of *property finance* – taken in its broad sense to include both the financing and marketing of real estate as well as the securitization of real estate and rental income receivables – are common to all professional operators, irrespective of where a real estate loan is applied for or granted.

The authors of this study have taken this fact as their starting point: from the identification of the borrower to the various stages of due diligence for structured financing; from the specific loan drawdown arrangements to repayment plans; from issues relating to loan syndication to forms of "direct" participation by the lender in the business risk associated with the loan through hybrid financing. In this context, it is instructive that the largest specialist operators often have a significant local presence, as part of their constant and on-going quest for the ideal mix between financial return and risk, which is evidently dependent upon the optimization of investment portfolios and the individual propensity for risk.

Leaving aside for one moment the fact that, from a strictly technical point of view, core skills are identical, it is clear that the formalities associated with structured financing cannot occur in isolation from the legal framework. The relevance of the statutory framework is not strictly limited to the regulation of the contractual instrument of choice. It is indeed indispensable that a close examination of the various ramifications of the legal position, considered overall, be carried out: from issues falling under civil law *lato sensu* (including the enforceability of guarantees, along with the liability of the guarantor in cases involving the issue of a comfort letter) to various questions under corporate law (including the frequent instances of loans granted to Special Purpose Vehicles [SPVs] within a group context, which are hence subject to inter-group financing arrangements, *de facto* administration, and prospective liability on the part of the controlling entity); from tax law (needless to say, tax implications cannot be left out of the definition of structured financing) to procedural issues under civil law and the law on bankruptcy, both from the perspective of non-performing loans (a scenario which evidently cannot be neglected within an overall assessment of real estate financing) and with reference to the access to voluntary schemes of arrangement by a borrower or to insolvency proceedings.

From the inter-disciplinary perspective set out above, and in keeping with the supranational dimension chosen, the authors have paired up the "technical" part, which seeks to illustrate core skills relating to real estate financing, with a part summarizing legislative aspects in selected jurisdictions, drawing on the contributions of renowned property finance experts from the individual legal systems considered.

www.morri-mazza.com

It goes without saying that – due to obvious requirements of brevity, as dictated by the mandate of the study – it would not have been possible to provide an exhaustive illustration of the various complex legal aspects associated with real estate financing operations: also for that reason, an "operational" approach has been preferred which, rather than providing pointless technical explanations, provides operators with an immediate outline of the most significant aspects of the specific regulations applicable to property financing within each legal system considered.

Against this backdrop, irrespective of the structural differences between land law in civilian and common law legal systems, operators will find a straightforward explanation as to why, for example, the instrument of the *Grundschuld* is preferred in Germany over the traditional mortgage as the principal instrument used for real estate lending. An explanation will be provided for the failure to use letters of responsibility or the reticence in requesting comfort letters in the People's Republic of China, even where the borrower is a SPV controlled by an industrial group. The study will also suggest why Italian lenders tend to shrink from initiatives that encroach further on the management of borrowers in distress (even though – at least as a matter of principle – Italian lenders have voting rights in the borrower's shareholder meeting).

The extension of the scope of the study to legal issues undoubtedly also reflects the broad professional experience built up by the authors in the real estate financing sector. This reflects their awareness that decisions specifically relating to real estate financing cannot fail to adopt an inter-disciplinary perspective. The analysis is complemented by the skilful pairing up of illustrations of fundamental theoretical issues from property finance with their "operational" implications, as is eloquently demonstrated by the examples illustrating individual structured financing operations.

Publication of the study by Giacomo Morri and Antonio Mazza comes in the wake of the end – in Europe as well as the USA – of the long recession sparked off by the US sub-prime mortgage collapse.

As is known, the economic and financial crisis – the most serious peacetime crisis since the Great Depression – was caused to a significant extent by the progressive distancing of increasingly sophisticated real estate financing operations from the theoretical fundamentals of text-book finance.

Against this background, a real estate financing study that strikes a happy medium between theoretical aspects of property financing and the practical implications of instruments underlying real estate financing (and hence of the instruments enabling risk to be measured and allocated correctly) undoubtedly aims to achieve a greater awareness on the part of property finance operators – hailing predominantly from the private sector – of their individual responsibilities. Indeed, an acknowledgement of the central role played by the private sector and of its own responsibilities was, perhaps not by chance, very recently recognized by US President, Barack Obama, as a "rock-solid foundation to make sure the kind of crisis we just went through never happens again".[1]

Milan – Frankfurt, August 2014

Alessandro P. Scarso

[1] B. Obama, Remarks on Responsible Homeownership, speech given in Phoenix (AZ) on 6 August 2013: "First, private capital should take a bigger role in the mortgage market. […] I believe that while our housing system must have a limited government role, private lending should be the backbone of the housing market […] Second, no more leaving taxpayers on the hook for irresponsibility or bad decisions. We encourage the pursuit of profit – but the era of expecting a bailout after your pursuit of profit puts the whole country at risk is over".

Acknowledgements

The publication of this book was made possible thanks to the support of Alessandro P. Scarso. Our thanks to Alessandro not only for his valuable operational support, but above all for believing in the project right from the outset. Alessandro's coordination of the country reports described in Part Two enabled an international comparative approach to be pursued. Our sincere thanks also go to all the authors and respective law firms that submitted the country reports in Part Two (in alphabetical order of the respective jurisdiction): Taylor Wessing (Shanghai, Nabarro LLP – London), Patrick Ehret and Sandra Inglese (Schulze & Braun – Paris/Strasbourg), Christoph Keller (PLUTA Rechtsanwalts-GmbH – Munich), Pragati Aneja, Nihit Nagpal, Puneet Dhawan, Mayank Kumar, and Amitabha Sen (Amitabha Sen & Co – New Delhi), Alessandro P. Scarso (Studio Legale PLUTA GmbH – Milan), Joaquim Sarrate (PLUTA Abogados y Administradores Concursales SLP – Barcelona). As a result of their thorough analysis and first-hand experience of real estate finance in their legal systems, they have ensured that the book will be relevant and usable in many countries throughout the world.

Special thanks are also due to Paolo Benedetto (SDA Bocconi and Europrogetti & Finanza), a dynamic academic and real estate professional who has worked alongside the authors for a number of years. Our gratitude to him not only for his contribution to the book, but also for his sterling work as project manager and his on-going and scrupulous review of the entire book, as well as his unfailing and indispensable help throughout all stages of the project.

We are also most grateful to Federico Chiavazza (SDA Bocconi & Avalon Real Estate), Andrea Artegiani (MSc Bocconi University), and Michele Monterosso (ING Commercial Banking) for their support.

Important operational assistance was provided by Thomas Roberts, who translated parts of the book from Italian to English and who supported us during the language review stage.

Last but not least, we owe profound thanks to PLUTA-Rechtsanwalts-GmbH, Studio Legale PLUTA GmbH, and PLUTA Abogados y Administradores concursales SLP for their generous financial support.

Naturally, responsibility for all errors lies solely with the authors.

Giacomo Morri, Antonio Mazza

Reader's Manual

Part One addresses economic and financial issues common to any real estate finance. Chapter 1 [*Introduction to Property Financing*] offers an overview of structured financing, highlighting the differences between corporate finance (where the lender's object of analysis is a legal entity) and project finance (which focuses on cash flows and also the manner in which the banks procure the capital used for lending). Chapter 2 [*Structured Real Estate Financing*] is dedicated to bank loans to the real estate sector, while Chapter 3 includes a detailed discussion [*Loan Agreement*] of the structure of a bank finance agreement along with its principal clauses. Again adopting a highly practical approach, Chapter 4 [*Loan Repayment, Interest and Renegotiation*] addresses the manner in which interest is charged. A broad overview of the capital repayment plan as well as the possibility to renegotiate the terms where difficulties are encountered in repayment are also dealt with. Chapter 5 [*Effects of Financial Leverage on Real Estate Investments*] provides a further discussion of financial models and outlines, by means of examples, the mechanics of financial leverage and the consequences associated with various levels of investment risks. To enable a better understanding of the contractual and financial dynamics of real estate finance, examples of typical real estate operations which analyse the term sheets of the relative loan agreements and construct models for assessing their financial sustainability are provided in Chapter 6 [*Structured Real Estate Financing Case Studies*]. The more practical part concludes with a section on hybrid financing [Chapter 7 *Hybrid Forms of Financing*], alongside more traditional forms of bank lending (pure debt), introducing a form of capital that is in part remunerated with reference to the outcome of the transaction. The concluding Chapter 8 [*Basel Accords and Effects on Real Estate Financing*] illustrates the effects of the Basel Accords on real estate finance, bringing the reader back to problems which are perhaps less practical; while not encountered on a daily basis, they are nevertheless of great importance in understanding the dynamics of real estate finance.

In Part Two the peculiarities of property finance in seven jurisdictions (China, England and Wales, France, Germany, India, Italy, and Spain) are addressed in greater detail by prominent lawyers specializing in property finance through answers provided to a predetermined set of questions. The latter cover most of the issues presented in Part One, thus providing a hands-on insight into structured finance transactions in the respective domestic jurisdictions.

The book contains numerous examples of contractual clauses and financial models that transpose financing contracts into figures. In particular, the calculation tables are freely available in Microsoft Excel format along with all active formulas, which will enable readers to run their own simulations in order to understand how financial models are constructed. The files relating to the examples are available on the website www.morri-mazza.com along with further discussions and updates on the main issues addressed:

- new academic and professional papers;
- link to websites on the topics;
- PowerPoint presentations for every chapter, in order to summarize the main ideas or for teaching purposes.

Moreover, personalized and tailor-made PowerPoint presentations will be prepared and made available free to teaching staff.

This book is intended for all players (financial institutions, investors, technical advisors, lawyers, brokers, etc.) who wish to engage with the capital markets using the common language of real estate finance. It is structured in a user-friendly manner, enabling readers to gain an overarching vision of the principal problems associated with real estate finance, whilst providing detailed practical analysis of the contractual and financial foundations of operations. It is also directed at university students who wish to consider any of the many issues (economic, financial, technical, or legal) associated with structured real estate finance in more detail.

Needless to say, although the book aims at outlining factors common to any structured real estate finance, and – hence – sets out the principles, rules, and techniques applicable internationally, as a matter of convention the examples are presented in Euros. Of course, nothing would change were the dollar, renminbi, or any other currency to be used. The choice to refer to the Euro appeared best to express the international outreach of this book, as it is a symbol of internationalization, having brought together a range of countries within a single currency.

Any comments, critiques, suggestions, or information from readers are very welcome. Please feel free to contact the authors by e-mail at authors@morri-mazza.com.

www.morri-mazza.com

PART One

www.morri-mazza.com

CHAPTER 1

Introduction to Property Financing

The concept of financing, understood in its broad sense, embraces all sources of capital investment and, as such, the definition covers both debt and equity indiscriminately. The term financing is indeed taken to apply to any form of capital which may be used to finance an investment project, ranging from the more traditional forms to those which are more innovative, and including both the use of equity capital as well as the various forms of debt capital.[1]

The procedures for investment financing are extremely important since they make it possible to improve the investment's ultimate economic result due to the lower cost of the invested capital when debt is used. Moreover, in order to undertake a profitable investment, it must also be financially sustainable, e.g. it must be possible to secure the necessary resources. Eventually, this must all occur in a balanced manner in order to ensure that there is not an excessive financial risk due to the fixed cost of interest payment.[2] Indeed, were the latter to exceed a certain threshold, it would reduce the economic benefit of lower capital costs and, at the same time, make the investment overly complex due to the excessive restrictions imposed by lenders.[3]

1.1 FORMS OF FINANCING: DEBT AND EQUITY

The various forms of capital used to finance an investment can be arranged along a continuum ranging from the two extremes of (pure) debt and (pure) equity. In order to understand where best to place each form of financing it may be of assistance to define some of the main characteristics of these two main forms.

[1] Whilst this book will mainly address the issue of real estate financing through debt capital and bank lending, it is fundamental also to consider the full capital structure: general considerations relating to equity capital in terms of the measurement of expected returns and collection procedures also apply to the real estate sector. A choice has therefore been made to dedicate greater attention to forms of debt capital which are specific to the real estate sector, giving only marginal consideration to problems relating to equity capital when issues relating to hybrid financing (such as mezzanine finance and preferred equity) are addressed.

[2] On financial risk please see also Chapter 5.

[3] In the book the term lender is mainly used for the bank, but the term financier is also commonly used synonymously.

www.morri-mazza.com

1.1.1 Debt

Debt capital is characterized by:

- an explicit cost defined under contract;
- the absence of any link between its cost (e.g. leading to different remuneration for the lender) and the actual return of the investment financed;
- tax deductibility in most cases.

The cost of debt is explicit since it depends upon a contractual agreement between the borrower[4] and the lender. This cost is precise and defined and (subject to certain limits such as in cases of default) is independent of the actual return of the investment financed since a set amount of money must be paid. Furthermore, the procedures and maturity dates for repayment are determined in advance and specified under contract.

Moreover, under most tax regimes, interests on debt are tax deductible,[5] thereby contributing to enhance the equity's return by reducing the tax burden. Although the financial advantage of using debt[6] results from this characteristic, debt financing continues to be used for various reasons, even where there are no tax benefits, such as:

- capital rationing (lack of equity capital);
- risk diversification;
- increase in projected earnings (in return for a greater risk);
- greater control over management.

Real estate investments, due to their large size, usually involve a significant debt-financing element. In fact, most operators work under capital rationing constraints, since they do not have access to all the capital which is necessary in order to implement all value creating projects with positive net present value (NPV). In particular, the real estate market is not efficient enough to swiftly allocate resources to projects with positive NPVs which therefore often cannot be implemented due to the lack of adequate financing. In addition, for many investors the recourse to debt financing is fundamental since they may wish to distribute their equity capital over several investments in order to reduce the concentration of risk within the portfolio as a whole. This is often the case of tax exempt investors, that notwithstanding the absence of tax shield benefit, use leverage in order to have a better diversified property portfolio.[7]

In other cases, such as for opportunistic funds, the quest for a high return results in the financial risk[8] being added to the (sometimes already significant) operating risk, without however directly creating value (in the sense of generating a higher NPV), since the higher return (greater cash flow to equity) is counterbalanced by a higher risk (equity expected return or consequently a higher discount rate).

[4] In the book the term borrower is mainly used as synonymous with client, the entity receiving money.
[5] Interest due on loans is often tax deductible, although there are limits in certain jurisdictions. The issue will be considered in greater depth in Part Two of the book which is dedicated to specific legal systems.
[6] Starting from the seminal work of Modigliani and Miller (1958), there is a wealth of literature focused on the advantages of debt. On the importance of tax deductibility please see Miller (1988).
[7] Geltner et al. (2007).
[8] On leverage and risk please see also Cummings (2010) and Geltner et al. (2007).

www.morri-mazza.com

Finally, whilst it may be less relevant for real estate investments, the need to service the debt limits management's discretion and facilitates investor control, as agency costs.[9]

Properties are apparently well suited to be financed with high amounts of debt because they can easily be provided as security as they cannot be concealed, their value is quantifiable with a fair degree of precision, and they represent sound collateral thanks to the possibility of mortgage guarantees. Moreover, the bankruptcy cost[10] is lower than that registered in other sectors (such as manufacturing or services) because the value of a property,[11] especially if it already exists or is already generating income, is less influenced by the owner and hence by the company going concern. The situation is different for companies in which the disposal value of individual assets is often irrelevant compared to the operating value of the company. However, complexity may increase significantly even in the real estate sector, and in particular in development projects, leading to an increase in the bankruptcy costs when the developer's role becomes fundamental for the successful completion of the operation.

The possibility of guaranteeing the debt by mortgaging the properties in respect of which the loan is granted apparently reduces the exposure of lenders to the risks generally associated with these type of investments, and therefore disposes them more favourably towards financing these operations. However, the value of guarantees[12] is heavily influenced by the legislative regime and the time-scales for enforcement procedures which enable them to be effectively implemented.

Real estate financing agreements may come in many different forms, and are specifically tailored to the characteristics of the individual operation, the parties involved, and market conditions.[13]

Within a sector which has undergone significant changes over time, lenders also play a significant role in promoting the use of more advanced techniques, such as mezzanine and private equity financing,[14] instead of traditional bank financing instruments alone. Depending upon the level of risk which lenders decide to accept, they may accordingly receive a share of the profits and play a more significant role in the capital structure.

Existing financing methodologies may be subdivided into two main categories:

1. financing instruments identifying a specific contractual form (such as mortgage loans, financial leases, or ordinary shares);
2. financing techniques which specify financing methods made up of multiple instruments (such as hybrid mezzanine financing with a mortgage loan and an equity kicker).

The financing technique therefore assumes that various financing instruments will be used in conjunction with one another in order to best satisfy more complex and detailed requirements.

---

[9] Jensen and Meckling (1976).

[10] Warner (1977).

[11] Brueggeman and Fisher (2011).

[12] In Part Two of the book guarantees in different legislative systems are analysed.

[13] The examples and methodologies which will be presented cover only some of the solutions most frequently used when concluding loan agreements. However, since the contracts concerned are negotiated on a case by case basis, the clauses may be created and amended taking account of the specific requirements of each individual case. As a matter of fact, operations on commercial properties are increasingly characterized by their implementation through ad hoc structured loans.

[14] On mezzanine finance and private equity see also Willis and Clark (1989).

www.morri-mazza.com

1.1.2 Equity

The definition of equity includes all forms of capital contributed by shareholders and any money pertaining to such contributions. In addition to paid-in capital or contributed capital, equity also includes retained earnings and treasury stock, if any. Equity is characterized by:

- an implicit opportunity cost;
- a remuneration which depends upon actual economic performance, and is payable after all other investors;
- non-tax deductibility.

Contrary to the position for debt financing, equity is characterized by the lack of a maturity date for repayment, or indeed of any formal obligation to repay. Expected remuneration will depend mainly on the perception of the overall risk, including the operational risk (investment type, procedure, and sector) and the financial risk (amount of capital with higher seniority than equity).

Finally, there is also a form of mixed capital, consisting in mezzanine financing or preferred equity, which covers all hybrid forms which cannot be classified either as debt, or as equity capital (for example profit participating loans, convertible bonds, and subordinated loans), since they share the characteristics of both.[15]

1.2 A DIFFERENT APPROACH TO PROPERTY FINANCING

A different way of conceptualizing financing is to consider the two parties, the shareholder (equity) and the bank (debt), simply as two partners which contribute capital to the same investment in different ways. The equity contribution will grant entitlement to control or manage the transaction[16] and to a residual payment after the partner bank has been remunerated. The bank, by contrast, on the one hand has less control (or even indirect control through covenants and guarantees), but nonetheless has a priority right to payment.

However, it must be recalled that taxes play an important role within the capital structure,[17] since the weight of the capital provided by the two partners has a different effect on the net result. Essentially, a high investment by the bank partner (e.g. the presence of a high level of debt financing) has an effect on taxes (since interests are deductible) and hence on the net remuneration of the other partner providing equity capital.

When analysing a real estate financing deal it is appropriate to put oneself in the shoes of the sponsor[18] of the initiative (usually the equity investor) who has to assess the sustainability of the capital structure; the same considerations work taking into account the (apparently) different perspective of the bank (the lender). In any case, the aims of the two parties should be aligned

[15] On hybrid forms of financing please refer to Chapter 7.
[16] This term will be used with reference to the real estate investment to be financed.
[17] On capital structure choices in the property sector:
- on the European market please see Morri and Cristanziani (2009) and also Brounen and Eichholtz (2001);
- on the U.S. market please see Feng et al. (2007) and Morri and Beretta (2008);
- on the U.K. market please see Ooi (1999).

[18] The term "sponsor" usually refers to the partner which brings capital (equity), expertise, strategies, and possibly contacts for the success of the project.

www.morri-mazza.com

with each other, that is in searching for investments which correctly remunerate invested capital. It is accordingly clear that the techniques for analysing the investment should not be different for the sponsor of a project (the equity investor) and the bank (the debt investor or simply the lender).

1.3 CORPORATE FINANCE AND PROJECT FINANCE

Compared to other forms, real estate financing is characterized by a common feature, namely the procurement of the financial resources required by the borrower from the value of the property provided as security, and hence from its projected cash flows.

Whilst they may be straightforward from a financial point of view, real estate assets may also be financed using highly complex structures and techniques, and no longer solely through traditional means such as a mortgage loan. For a long time, financing in the real estate sector has been based on a limited number of instruments. Mortgage loans have been predominant for a long time and banks have regarded such a state of affairs in a favourable light since it makes it possible to tie in the borrower for a relatively long period of time, in addition to the rather contained level of risk thanks to the mortgage guarantee. Today, however, particularly since the Global Financial Crisis, banks too appear to be dedicating greater attention to real estate financing by privileging project finance solutions, in which the individual transaction is assessed from the same perspective as that of the equity investor. The reliability of the borrower in terms of management capacity does remain important, although the focus of analysis is becoming increasingly centred on the project itself.

The distinction between companies and projects may often appear to be somewhat theoretical since in reality it is not equally easy to draw this distinction, given the significant overlap between real estate projects and investments and SPVs. Consider the differences between a project finance arrangement[19] (which, as the name suggests, is an instrument for financing a project), under which the return is associated with the project's ability to generate cash flows to remunerate investors, and a mortgage loan (which is an instrument for financing an asset), the disbursement of which in many cases depends upon the value of the asset and the registration of a mortgage on it.

An investment project secures sources of finance, whether through debt or equity, according to its future capacity to generate cash flows to make payments. Depending on the object of the loan a particular approach may be adopted:

- corporate finance, focusing on the loans disbursed to a party (e.g. a company);
- asset based, in which lending activity is directly associated with a specific asset (e.g. mortgage loan or financial lease);
- cash flow based, under which loans are disbursed to a project (e.g. real estate developments or projects operating under concession as Private Public Partnerships).

Depending upon which of the previous approaches is adopted, the guarantees requested by the lender will differ, and so consequently will the risk profile. Within a corporate finance approach, an assessment of the corporate situation will take on significance in guaranteeing

[19] There is a wide literature on project finance; a selection of relevant books and articles includes Gatti (2013), Dewar (2011), Esty and Sesia (2011), Lynch (2011), Hoffman (2008), Yescombe (2002) and Fabozzi and Nevitt (2000).

www.morri-mazza.com

the loan, whilst within an asset based approach the collateral value of the guarantee will predominate. Finally, under a cash flow based approach the quality and volatility of the project's cash flows will be paramount. The last two approaches are becoming increasingly predominant for real estate financing when there are no guarantees external to the project, whilst corporate financing is often reserved to larger real estate companies or funds, although this will always be accompanied by guarantees on properties.

When choosing between corporate finance and project finance approaches, a fundamental difference lies in the principles used in order to ascertain creditworthiness. Moreover, whilst project finance arrangements may be more flexible because tailor made to a specific transaction, by contrast they have a more complex structure.

According to the corporate finance approach, lenders will assess the economic and financial equilibrium of the company which intends to carry out the investment, using the company accounts as their basic instrument, but also the impact which new investments and the relative financing will have on these accounts. It is also necessary to predict the company's future performance by identifying the internal factors (such as strategies and assets) and the external factors (such as the conduct of competitors, and the performance of the market, the industry, and the economy in general) which influence it.

From the project finance perspective on the other hand, the assessment concerns the economic and financial equilibrium of the project to be financed, which is separated in legal and financial terms from other assets of the sponsors through the creation of a dedicated SPV, thereby ring-fencing the investment in order to isolate it from the sponsors' core business or other assets. In this way, should the project be unsuccessful, the sponsors' assets will not be affected in any way; similarly, should other projects be unsuccessful, the relevant creditors will not in turn be able to seek satisfaction on the ring-fenced property. The situation therefore involves a non-recourse form of financing.

Corporate finance involves the granting of bank loans, but also bond issues, that is debt securities issued by financial institutions or companies providing for repayment of the capital loaned either upon maturity or in instalments determined in advance prior to maturity. In this way there is a clear separation between the investment and the loan and there is no clear correspondence between the in and out cash flows.

In contrast in the case of a structured financing, the assessment as to the convenience of the project may already be made with reference to a specific form of financing.

The choice between corporate finance and project finance approaches depends upon various factors, including whether it is preferable to include the new project within the sponsors' assets and to attempt to secure financing through the traditional lending channels, or whether it is more appropriate to incorporate a specific vehicle which will secure financing in its own right.

1.4 BANK FINANCING

Real estate bank financing may be classified under three principal headings depending on the borrower and the purpose of the loan.

1. Property loans granted to private (retail clients) intended:
   - **(a)** for the purchase of a residential property;
   - **(b)** to refinance the purchase of a residential property with a new loan;
   - **(c)** to provide liquidity in order to cover an expense or home refurbishment.

www.morri-mazza.com

2. Property financing granted to companies intended to cover the company's financial requirements (e.g. new investments or capital expenditures on existing properties).
3. Structured property financing granted to companies or real estate funds (including SPVs), intended:
   (a) to finance the acquisition of an income producing property or a trading portfolio of properties;[20]
   (b) to finance the construction/reconstruction costs of properties to be leased or sold.

There is a substantial difference between the first two classes of financing and the third one. Within retail or corporate real estate financing, the bank's due diligence is focused on the capacity of the borrower (either a private individual or a company) to generate sufficient income to repay the loan. The property is only a guarantee which the bank may enforce in order to extinguish the loan, should the borrower become insolvent. On the other hand within structured real estate financing, the bank's due diligence is focused on the property and its immediate or projected capacity to repay the loan through the income generated from lease or sale.

1.4.1 Property Loans to Private Individuals

The main guarantee which is requested by the banks for the first type of loan is the creation of a first ranking mortgage on the property – either owned or pending purchase – by the private individual applying for the loan.

For these loans the bank will verify the ability of the borrower to repay the loan out of his or her income, either from their job or other sources. If there is no or inadequate income,[21] the loan may be granted only once a guarantee has been issued by a third party in receipt of sufficient income. As a general rule, monthly loan repayments should not exceed one third of the net monthly income of the borrower (and/or guarantor).

Because of the ease with which the technical, legal, and economic due diligence phase of the operation can be standardized, loans for residential properties are offered by all commercial banks and now also more and more via the internet.

1.4.2 Property Financing to Cover Financial Requirements

Also for property loans the main guarantee provided is the establishment of a first ranking mortgage over one or more properties of the company or of the company shareholders. The ability to repay the loan is generally assessed on the basis of a profitability indicator of the company (usually EBITDA[22]).

[20] Property portfolios bought at discount ("wholesale") with the purpose of the sale of individual properties ("retail") over time.

[21] As a general rule, periodic loan repayments should not exceed a percentage of the net income of the borrower (and/or guarantor): for example, in the Italian market, monthly loan repayments should not exceed one third of the net monthly income, while UK banks use a multiplier (currently between 4 and 5) of gross annual income which the loan cannot exceed.

[22] EBITDA, or *Earnings Before Interest, Taxes, Depreciation and Amortization*, is a profitability indicator focusing on the company's income which is based solely on gross ordinary revenues, that is before interest (financial management), tax (tax management), depreciation of assets, and amortization.

www.morri-mazza.com

However, these loans are closer to corporate loans that are related to the business carried on by the borrower and to its capacity to generate cash flows through its core business (which for example may involve manufacturing, commerce, or the provision of services by anything from a major conglomerate through to a small trader).

In some cases, guarantees are offered by a company which, like the borrower, belongs to an aggregation of companies, all of which are legally independent in terms of their assets and corporate identity, but which are associated on an organizational level (a group of companies). The business group will generally be headed by a parent company, which may be a pure holding company when it directs and controls the other companies through the holding of equity interests, or operational when its role is limited in carrying out the economic and financial functions necessary in order to guarantee the orderly activity of the subsidiary companies.

Generally speaking, the existence of a business group will not always constitute sufficient justification to permit a company to provide guarantees in favour of another company from the same group. In several jurisdictions (especially those influenced by the Civil Law) it is necessary that there are also some indirect benefits for the guarantor, resulting from the pursuit of a group interest. If the asset in relation to which the loan guaranteed is requested will have a positive impact for all of the companies involved (including both the guarantor and the guaranteed company), this will establish a justified reason for the guarantee. However, if there is no such interest then the guarantee will have no effect. For this reason, the business plan which can justify the provision of sureties by one of the companies in the group for the debts of another group company should be rigorously documented. This financial and investment plan has to be agreed to by all group companies and provides for the distribution of benefits between all parties in line with the costs incurred.

Property loans intended for companies are generally granted by banks which also carry on corporate financing business or which have a bank or division operating in this sector within the reference banking group.

1.4.3 Structured Real Estate Financing

Structured real estate financing operations (the project finance approach) will preferably be directed at SPVs. The separation between the real estate project to be financed and the operations of the sponsors of the asset will ensure that they are economically and financially isolated (ring-fenced financing) and will in turn benefit both the sponsors of the asset as well as the lending banks.

The parties involved in the due diligence process for the loan application (surveyors, financial analysts, and lawyers) working for structured real estate financing companies will require a high degree of specialization in the real estate sector.

The following chapters will focus on structured bank lending (according to a project finance approach) directed at financing commercial real estate operations; residential loans to private individuals and corporate loans are not the focus of this book.

1.5 FUND RAISING, SECURITIZATION, AND SYNDICATION

This paragraph will illustrate two important aspects which characterize the activity of banks providing finance to real estate investments: fund raising, e.g. the systems by which the banks collect money on the market in order to reallocate it to the disbursement of real estate loans,

www.morri-mazza.com

and loan syndication, e.g. the procedure whereby the initial lending bank shares the loan with other banks, or assigns all of the amounts due through securitization. Whilst the collection of funds is a necessary part of a bank's operations (as a financial intermediary), syndication and securitization are optional activities which have favoured the consistent disbursement of real estate loans even by smaller banks.

1.5.1 Traditional Funding and Securitization

Within this context it is important to recall that according to the traditional system for granting real estate loans, once the bank has obtained the funds, it grants the borrower the loan and the relative receivable remains due to the bank for the full term of the loan. Consequently, the relationship between the bank and the borrower has the same duration as the loan and any default on the loan will only affect the lending bank, which therefore has a strong interest in processing the loan application properly and in adopting a medium to long-term view of the operation.

Under the traditional system, the value of loans granted was thus directly proportional to the banks' assets, which have to guarantee, amongst other things, the relative credit risk on loans granted. In contrast, under a system based on securitization,[23] the banks assign their loans (even immediately after the operation is concluded) to third parties (which are not necessarily banks) which, in a nutshell, issue stocks on the market in order to finance the operation. The lending bank need not have any interest in attending to the fund raising activity (it will raise short-term funds), nor necessarily in establishing a lasting relationship with the borrower. After the assignment, any default by the borrower will be of no consequence for the original lending bank, but only for the parties which bought the notes issued on the market as part of the securitization process. The amount loaned in circulation is potentially infinite because it is no longer associated with the rigid capital requirements applicable to the banks.

In general, the technique of securitization consists in the conversion of various forms of assets into securities which can be readily traded on the market. This technique makes it possible to discount to the transaction date the present value of future cash flows which will be generated by the securitized assets. The transaction therefore makes it possible to finance the cash flows which one party, defined as the originator of the transaction, will be entitled to receive in future as a result of the collection of receivables or the sale of assets.

The securitization starts with the sale of those assets and is subsequently completed with the issue of the notes on the financial market. The cash flows resulting from loans, mortgages, and other assets (such as immovable properties) provide the guarantee for the notes issued and the means of ensuring their repayment.

More precisely, the assets at issue in the transaction are transferred for consideration from the originator to the transferee, which acquires them in return for payment of a fee: this transaction is financed through the issue of notes which are placed on the retail market or with institutional investors.

The former transactions were first concluded on the US market in the second half of the 1970s in order to transform the receivables of financial institutions into cash. However it was

[23] For further references on securitization please see also Stone and Zissu (2012), Fabozzi et al. (2007), Sabarwal (2006) and Fabozzi and Dunlevy (2001).

www.morri-mazza.com

only later that this instrument was applied on a large scale to mortgage loans within the real estate market and the mortgage loans market.

Securitization offers banks a way of securing financing by enabling them to assign the loans they have granted to investors, thereby freeing up capital for new credit transactions.

1.5.2 Funding for Real Estate Loans and Syndication

The traditional fund raising systems are the "German system" and the "French system". The German system of fund raising is characterized by the close relationship between the fund raising activity and the lending activity which is reserved to specialist banks in certain countries. Very often this link is established upon conclusion of the loan agreement and must also be maintained for the full repayment term of the loan. The French fund raising system is characterized, by contrast, by a separation between the fund raising activity and lending.

The banks are free to choose which system of fund raising they wish to use, whether French, German, a mixture of both, or others, given that fund raising activity is essentially free from constraints. Nevertheless, the banks must adopt suitable measures in order to control and manage the risks associated with these activities, including the risks resulting from the mismatching of balance sheet asset and liability maturity dates and the risks inherent in medium to long-term lending to businesses. One of the most important and delicate activities within a bank is that carried out by the treasury department which has to keep under control the following critical issues:

- What happens if the bank uses current account deposits for granting loans (or part of them), and all of the funds are withdrawn by clients from current accounts, which are instant access accounts?
- What happens if the maturity of the funding does not match the maturity of the loans?
- What is the stable level of current account deposits which may be relied on for a corresponding medium to long-term commitment?
- What happens if interest rates rise or fall? Are there sufficient guarantees to cover that risk?
- What happens if the fund raising is in Euros and lending in dollars (or vice versa)?

Under the French system banks usually resort to the interbank market in order to raise funds and buy money at a cost which depends upon the market's perception of the risk of the borrowing bank. For this reason, a bank with a high rating may offer more beneficial terms to its clients than banks with worse ratings, precisely because it can secure funding at a lower cost.

Under the German fund raising system, funds could be secured on an ad hoc basis and are referred to as covered bonds. Covered bonds (*Pfandbrief*), which were established more than a hundred years ago in Germany, were introduced in other countries such as the United Kingdom, the Netherlands, and Italy. Previously each issue was defined on the basis of genuine contractual agreements. They are now used in 22 European countries.

In contrast to securitization operations, covered bonds guarantee a return on capital and interest since part of the bank's assets are burdened and are earmarked exclusively for the remuneration and repayment of these instruments, which are in any case also guaranteed by the issuing bank.

For the bank issuing the covered bond, the difference compared to securitization is that their issue does not make it possible to remove the transaction from the bank's balance sheet

www.morri-mazza.com

(precisely due to the existence of the guarantee), which means that the bank will continue to bear the credit risk, and is required to make the relative capital allocations in its accounts.[24]

Covered bonds offer greater security compared to traditional bonds, and consequently greater liquidity accompanied by higher ratings and lower returns.

Covered bonds should accept a lower return compared to normal medium and long-term fund raising systems: covered bond holders may enforce their rights directly against the assets set aside which are beyond the reach of the bank's other creditors. If for example the bank's credit rating were "B" and that of the covered bond were "A", the bank would have an undoubted advantage in issuing this instrument in order to raise funds for its own real estate lending operations. As a consequence banks issuing covered bonds can lend to their clients at lower rates because of the lower cost of funding.

Covered bonds are mainly characterized by:

- the guarantee relating to the ring-fencing of the receivables assigned to the vehicle which ensures that they will be dedicated, along with the cash flows generated by them, exclusively to satisfying the subscribers of the covered bonds;
- certain guarantees of the issuing bank relating to its assets and a self-standing commitment by the vehicle in the event of default by the issuer.

1.5.3 Syndication of Real Estate Loans

If the lending bank is not able or willing to underwrite the loan in full, or if it is required to reduce its credit exposure towards certain clients or sectors, it will be necessary to involve other banks: this operation is generally referred to as "Syndication".

Syndication may occur upon conclusion of the loan agreement, or after it is concluded. In the former case, the operation will be concluded in a pool with other banks (also referred to as a club deal). In such cases no particular problems arise either with regard to the conclusion of the agreement or to the guarantees of equal ranking which will be provided to all of the banks. In such cases it is settled practice to conclude an interbank agreement to regulate relations between the banks, also specifying which of them is to act as the agent bank with the task of coordinating the interaction – which does not always run seamlessly – between the various banks during negotiations with the borrower and of administering and monitoring the loan during the post-disbursement stage (the agent bank is normally the one which establishes relations with the client).

In other cases, especially when it is not possible to wait for a long time in order to conclude the club deal, the bank will finance the transaction with a bridge loan, e.g. a short to medium-term loan. Before the bridge loan matures the bank and/or the borrower will contact the other banks in order to make provision for the mortgage on a pooling basis with a medium to long-term loan which will redeem the existing loan.

The problems associated with this structure are well known because the bank granting the bridge loan may not make a firm commitment also to sign the long-term loan in full, with the result that if it is not able to arrange the club deal before the bridge loan matures, there may be a default risk on the transaction.

[24] On capital requirements please see Chapter 8. Basel Accords and effects on real estate financing.

www.morri-mazza.com

In cases of construction financing (to be disbursed on the basis of a work in progress[25]) the agent/arranger bank may underwrite the full amount of the loan and sign the relative agreement (also accepting all guarantees) and may start making the initial disbursements. It will then start (or continue) to look for other banks which, once the transaction has been accepted, will sign a new financing agreement solely in respect of the part underwritten, requesting the borrower to issue the relative guarantees to them with the same ranking as those granted to the agent bank (and with the agreement of the latter). At the same time the agent/arranger bank will reduce its contractual commitment by an amount equivalent to that underwritten by the underwriting banks.

[25] WIP: in a broad sense both construction and commercialization work in progress.

CHAPTER 2

Structured Real Estate Financing

In a similar manner to project finance operations, structured real estate finance involves the funding of a transaction in which the bank accepts the cash flows generated, or which may be generated, from the property financed as collateral for the repayment of the debt.[1]

The due diligence carried out by the bank when granting these loans involves an assessment of the economic and financial equilibrium of a specific real estate asset or project, which will preferably be legally and economically independent of the other initiatives carried out by the sponsors which conclude the transactions. The real estate project to be financed will generally be implemented by its sponsors by creating a special purpose vehicle (SPV) which permits the investment to be separated in economic and legal terms.

A real estate project is assessed by the banks and its sponsors principally with reference to its capacity to generate revenues from the lease and/or sale (also partial) of the properties financed. The cash flows associated with the real estate transaction provide the source for servicing the debt as well as paying a return on the equity capital invested by the sponsors.

The guarantees may be real (e.g. pledge on SPV shares, mortgage on the property) or contractual (e.g. assignment of receivables as collateral, contractual covenants), although it is the contractual guarantees which actually assure the banks that the cash flows generated by the real estate asset will be the primary source for servicing the debt. These loans may be of two different kinds.

- *Non-recourse* or *without recourse*, when no right of recourse is specified (for example through the issue of guarantees or comfort letters) against the sponsors of the project or third parties. The capacity of the real estate project to generate sufficient cash flows (which are only potential in cases involving development projects) in order to repay the debt, along with a contractual structure that guarantees the success of the real estate investment and the repayment of the underlying debt, are the main elements to be assessed by the lending banks.
- *Limited recourse*, that is with recourse limited to situations in which rights of recourse are provided against the sponsors or third parties upon occurrence of situations specified in advance under contract. For example, in a development project where construction costs are only partially financed by the bank, the latter will demand from the sponsors a commitment or a guarantee to inject into the project both any capital shortfall arising during the construction phase, as well as funds to cover unexpected costs.

[1] Vinter (1994).

www.morri-mazza.com

Obviously, the bank will also carry out a financial credit check for non-recourse loans in order to verify the solvency of the shareholders and/or of the financial group of the borrowing company. The aim is to avoid any default by the transaction's sponsors affecting, even indirectly, the real estate project financed as well as to assess the resoluteness and reliability of all parties involved in the transaction.

The cash flows result from rent (either property leases or going concern leases), whilst in development projects they will be generated from the sale (or lease) of the individual units when construction work has been completed.

Debt financing is generally available for all types of real estate, provided that they can generate cash flows, both actual (for existing income producing properties) or expected (for development projects). Accordingly, the following properties, existing or to be developed, will be eligible to be financed:

- offices;
- high street retail/shopping centres/retail parks/factory outlets;
- entertainment centres/theme parks;
- multiplexes;
- hotels;
- logistic warehouses and industrial;
- retirement homes;
- residential portfolios (to rent and/or to sell).

The loan may be intended to support construction costs or to pay the acquisition price. In the former case, it will be necessary to provide a precise estimate of the costs of the project and of the cash flows which the property may generate once completed: the granting of the loan may also be conditional upon the sale of units successfully sold (particularly in case of residential development projects). In the latter case, it will be necessary to pay particular attention to the relevant clauses in the lease agreements.

The capital structure of a real estate project may be made up of three parts:

- equity (shares and shareholder loans);
- debt capital;
- hybrid financing (mezzanine finance and preferred equity).

The debt amount financed will mainly depend on three elements:

- the reliability of the borrower;
- the transaction for which the loan is intended and its operational risk;
- any guarantees provided.

This amount may be granted as one single credit line, although alternatively secondary credit lines may also be granted, such as for example a specifically dedicated VAT line.

In all cases, the equity that is to be injected by the sponsor cannot usually be less than 20–30% of the overall cost of the property. In development projects, this equity level often corresponds to the acquisition cost of the area to be developed. Since lower equity percentages will entail higher leveraging and higher risks for the bank, credit lines exceeding 70–80% of the construction cost (also defined as mezzanine finance) come with significantly higher costs.

CHAPTER 3

Loan Agreement

There are no standard terms and conditions for commercial structured real estate financing agreements, and each agreement is negotiated individually without any predefined standard form contracts. Moreover, the rules applicable to loan agreements differ from country to country, as more closely detailed in Part Two of the book.

The following rules and clauses are those which frequently appear in structured real estate loan agreements:

- parties[1] to the transaction (bank, borrower company, and guarantors, if applicable);
- object and purpose of the loan;[2]
- conditions precedent;
- amount of the loan;
- loan repayment schedule;
- allocation of the loan;
- interest rate;
- interest rate risk hedging;
- fees charged by the bank;
- frequency and procedures of drawdown;
- events of default (i.e. situations which will end the agreement or establish entitlement to terminate or withdraw);
- collateral;
- insurance;
- representations and warranties by the borrower;
- contractual covenants;
- duties to provide information;
- costs, taxes, and ancillary charges;
- clauses relating to assignment/transfer/syndication;[3]
- choice of law and jurisdiction.

---

[1] The loan agreement must be concluded by individuals representing these parties, duly vested with the power to sign, enter into contractual obligations, and provide collateral on behalf of the parties.
[2] For example, in order to purchase a single property, a portfolio of properties, or to fund a development project.
[3] Where provided for under the relevant legislation.

www.morri-mazza.com

The contents of the aforementioned contractual clauses will differ depending upon the relevant legislation in force in the country in which the agreement is concluded. In common law countries, all matters are regulated under the loan agreement as it is the only source of rules governing the relationship between the parties (bank and borrower). In civil law countries on the other hand, contracts should be more concise as it is possible to refer to statutory provisions as a source of regulation for the contractual relationship, which means that the sources of law applicable to the relationship are the contract and the reference legislation, which can often not be set aside in the contract.

Having clarified this aspect, the following sections will describe the most significant contractual clauses which are common to the various legal systems, while the clauses specific to each country will be described in Part Two.

CHAPTER 4

Loan Repayment, Interest, and Renegotiation

In the first part[1] of this chapter the most commonly used loan repayment schedules and interest calculation techniques are described, while in the second part issues related to loan renegotiation and restructuring are dealt with.

Since it is very important to have a loan repayment schedule that fits the operating cash flows of the financed real estate project, the described loan repayment schedules are the most typical scheme, but any kind of variation is possible depending on the financing agreement.[2]

[1] Also with the contribution of Andrea Artegiani, MSc Bocconi University.
[2] For further details on financial calculation see also Kolbe et al. (2003).

CHAPTER 5

Effects of Financial Leverage on Real Estate Investments[1]

This chapter presents the effects of financial leverage on real estate investments. As such, the chapter has three main objectives:

- to examine the impact of financing on the risk-return ratio as a function of two critical elements:
  - the loan to value ratio;
  - the difference between unlevered returns on investments and the debt servicing costs;
- to clarify the circumstances in which financial leveraging is appropriate;
- to provide some illustrations of the use of financial leverage.

The conduct of the analyses carried out in this chapter implies the inclusion of certain assumptions for the purpose of simplification regarding the return generating process and recourse to financial leverage.

A mono-period model has been used, as a variant of the Modigliani and Miller theorem,[2] which assumes that there are no failure costs associated with the investment:

$$K_e = \frac{K_a - K_d LTV}{1 - LTV}$$

with:

$$K_e = (levered)\ equity\ return,\ K_d = cost\ of\ debt$$

$$K_a = (unlevered)\ total\ return,\ LTV = loan\ to\ value\ ratio$$

[1] Edited by Federico Chiavazza, MRICS, lecturer in the Administration, Control, Corporate and Real Estate Finance Area of the SDA Bocconi School of Management. He is coordinator of the Real Estate Portfolio & Asset Management and Real Estate Development executive courses. After completing a degree in Corporate Economics at Bocconi University and a period of professional activity and further research, he was awarded a Master of Science in Real Estate by New York University. He currently pursues his academic activities in parallel with his work as a professional as a Partner at Avalon Real Estate, and as an advisor for some of the major players in the real estate sector.

[2] See Modigliani and Miller (1958).

www.morri-mazza.com

A situation involving financing with no failure costs implies that there is no correlation between the loan and total return. Consequently, the volatility of the equity return may be calculated according to the following expression:

$$\sigma_e = \frac{\sigma_a}{1 - LTV}$$

with:

$$\sigma_e = volatility\ of\ (levered)\ equity\ return$$

$$\sigma_a = volatility\ of\ (unlevered)\ total\ return$$

CHAPTER 6

Structured Real Estate Financing Case Studies

In order to achieve a better understanding of how structured financing works in the real estate sector, this chapter[1] will illustrate some practical examples.[2] Three case studies are presented from the borrower perspective: an income producing property (investment transaction), the acquisition of a property portfolio aimed at its disposal by single assets, and a residential development project. The fourth case study is presented instead from the lender perspective, by describing the analysis carried out by the credit committee of the lending bank. Even if the perspectives of the two parties may appear different, the analyses are similar with respect to the element of risk and the major financial elements considered.

For each operation an example of a possible term sheet relating to the structured financing will be presented, including comments on various items (some common items of minor importance will not be presented in the subsequent term sheets), along with the economic analysis carried out by the lending bank in order to assess the feasibility of the loan applied for, under the conditions proposed in the term sheet. For the purposes of simplicity, the models used will not contain any considerations relating to tax issues (both income and transaction taxes) and will present an extremely simplified cash flow model (before tax and without presenting the profit and loss account). The same considerations will also remain valid if a more detailed economic model is applied.[3]

---

[1] Written also with the contribution of Paolo Benedetto, SDA Bocconi Teaching Fellow and Head of Valuation Department in Europrogetti & Finanza. He has participated at the Executive Program in Real Estate Finance by SDA Bocconi and he holds a Master of Science in Finance with honours and an undergraduate degree with honours in Institutions and Financial Markets Management from Bocconi University. He has been an exchange student at the MBA Program of the University of Western Australia in Perth and at the Schulich School of Business, York University in Toronto. He has been member of the local organizing committee of ERES 2010.

[2] All of the names used in this chapter are fictitious and any similarity to the names used by actual business enterprises is entirely coincidental.

[3] For further details on the models please visit www.morri-mazza.com where you can freely download all the Excel spreadsheets used in the book and other materials.

CHAPTER 7

Hybrid Forms of Financing

Hybrid forms of financing, also defined as mezzanine debt financing and preferred equity, cover a range of flexible financial instruments with different technical characteristics, and may be combined to offer tailor-made solutions for specific financing requirements. These are not forms of capital financing which may be classified under traditional pre-existing forms, such as for example loan agreements, but rather forms of capital financing that are situated half-way between senior debt and equity, and which draw characteristics from both types of capital. This typically refers to mezzanine debt financing, which is fundamentally a subordinate debt, when the debt component is predominant, whilst the term preferred equity is used when the equity capital component prevails, and where there is hence a sharing of risk. For the sake of simplicity, the discussion of hybrid financing will refer to the more general term mezzanine,[1] unless it is specified in each individual case whether the debt or equity component prevails, depending upon the actual structure of the contract. Preferred equity solutions involve structured joint venture agreements in which there are two different classes of shares or fund units, under which the income and cash earned from the initiative may be distributed differently.

[1] For further references please see also Watkins et al. (2003).

CHAPTER 8

Basel Accords and Effects on Real Estate Financing

The Basel Accords on Capital Requirements are intended to ensure stability within the banking system, which necessarily has a knock-on effect on the stability of the economic system, stipulating, *inter alia*, the capital requirements for banks in relation to the risk taken on as part of their ordinary business.

The general principle on which these accords are based is that the risk taken on by a bank must be adequately backed up by its supervisory capital, which may be defined in summary terms as the capital which the banks must set aside in their balance sheets in order, *inter alia*, to cover the risks resulting from credit exposure towards their clients. Consequently, the greater the risk involved in operation, the more the bank will have to set aside funds to its supervisory capital, although these provisions may vary depending upon the risk of losses due to debtor default, which must be monitored and updated until the credit facility has been paid back in full.

The Basel Accords on the capital requirements for banks were concluded by the Basel Committee on Banking Supervision, which was established by the governors of the central banks from the G10 countries at the end of 1974 and operates under the auspices of the Bank of International Settlements, an international organization charged with the promotion of cooperation between central banks and other equivalent bodies, with the goal of pursuing monetary and financial stability.

In 1988 the Basel Committee introduced the capital measurement system commonly referred to as the Basel Accord on Capital Requirements (or "Basel I"), which was endorsed by the central authorities of more than one hundred countries, and which laid down the obligation for banks to set aside capital to cover 8% of loan capital in order to ensure solidity to their operations.

In January 2001 the Basel Committee published the consultation document entitled *The New Basel Capital Accord*, setting out new regulations on capital requirements for banks. In June 2004, following many months of consultations and controls, the final text (known as "Basel II") was adopted, whilst the implementation of the agreement – originally planned for 2006 – took place in a different manner in the various countries.[1]

[1] To have an update of Basel Committee members' progress in adopting the Basel Conventions, please look at "Progress report on Basel implementation", Bank for International Settlements (www.bis.org). This report focuses on the status of domestic rule-making processes according to the internationally agreed timeframes.

www.morri-mazza.com

Between 2010 and 2011 the members of the Basel Committee on Banking Supervision agreed to change the previous Basel I and Basel II Accords through a new Accord named Basel III. The third instalment of the Basel Accords was developed in response to the deficiencies in financial regulation revealed by the late-2000s financial crisis.

www.morri-mazza.com

PART Two

Outline of the most relevant legal issues in selected jurisdictions

CHAPTER 14

Italy[1]

1. What are the principal securities lenders will require borrowers to provide?

Securities which lenders will normally require borrowers to provide are:

- a first-rank mortgage on the financed property;
- the pledge over the shares of the borrower;
- the assignment of rental income;
- a pledge over the bank account where the rental income will be paid in as well as an order for the collection of the rental income;
- the assignment of insurance policies covering risks related to the destruction or deterioration of the financed property;
- the irrevocable mandate to sell the financed property;
- the commitment to treat intragroup claims as subordinate debt (irrespective of – and in addition to – any statutory provision, cf. for instance, s. 2467 Codice civile [Italian Civil Code – hereinafter "CC"]) as well as the issuance of a comfort letter or a "Letter of Responsibility" issued by the parent company/-ies, if any.

2. What statutory provisions apply to such securities?

The mortgage, the pledge, as well as single agreements (for instance, the assignment of rental income, the mandate, and unilateral declarations [for instance, the "comfort letter"]) are (primarily) ruled by the CC. Besides, ss 38–42 of the Consolidated Banking Act (*Testo Unico Bancario* – Legislative Decree no 385 of 1 September 1993 – hereinafter "CBA")[2] provide for a set of rules applicable to banks granting loans backed by mortgages (so-called "real estate loans" – *credito fondiario*).

---

[1] Alessandro P. Scarso, Tenured Professor of Civil law, Bocconi University, Milan; Lawyer and Chartered Accountant, Studio Legale PLUTA GmbH, Milan.

[2] S. 38-42 CBA (i.e. Chapter VI [containing provisions concerning certain credit operations], Section I [Real estate and public works credit], CBA).

3. What are the formal requirements for the establishment of such securities?

Mortgage A mortgage gives the creditor a right to seize the property bound to secure their claim – also against a third party transferee – and a priority over other creditors in the payment of their claim from the proceeds of the enforcement proceedings related to the mortgaged immovable property. Should a mortgage have been established by private deed, in order for it to be registered in the land register it will have to be authenticated by a notary (or any other authority to whom such power has been conferred) or judicially verified. The applicant shall present the original document establishing the mortgage or, if such writing has been deposited in public archives or filed with a notary, an authenticated copy thereof, in which the existence of the aforementioned requirements shall be certified. The original or the authenticated copy remains deposited in the land register (see s. 2835 CC). Should the grounds for the registration of the mortgage be a public deed made in Italy or a court decision or other judicial provision of equal weight, a copy of such deed shall be submitted to the land register (s. 2836 CC).

Pledge According to ss 2787(3) and 2800ff. CC, the pledge of claims and other rights (including shares) is established solely where the pledge agreement has been made in writing and the debtor of the claim given in pledge has been notified of the establishment of the pledge, or when the pledge was approved by such debtor in writing: for the priority treatment over other creditors to apply, the notification or the approval have to bear a "certain date" (pursuant to s. 2704 CC – see below).[3] However, if the claim is evidenced by a pawn ticket or other written document issued by duly authorized institutions which professionally engage in credit transactions upon pledge, the date of the writing can be established by any kind of evidence (see s. 2787(3–4) CC).

Assignment of rental income The assignment of claims (for instance, the assignment of rental income) is not subject to any formal requirement. Notwithstanding such freedom of form, in order to hold such assignment against third parties (for instance, against bankruptcy receiver, who is considered a third party for such purposes), a "certain date" is necessary (pursuant to s. 2704 CC),[4] which implies that lenders normally either have the signatures of the private deed authenticated by a notary or will execute a public deed.

Commitment to treat intragroup claims as subordinate debt For the commitment to treat intragroup claims as subordinate debt a private deed is sufficient. Shareholders' financings are treated as subordinate debt by operation of law pursuant to s. 2467(1) CC, according to which the reimbursement of financings of shareholders in favour of the company is subrogated to the

[3] According to s. 2704 CC, ruling the date of private deeds as to third parties, "The date of a private writing in which the signature has not been authenticated is not certain and cannot be asserted against third parties, except from the day on which the writing was registered or from the date of death or supervening physical incapacity to sign of the person or persons who signed it, or from the date on which the contents of such writing are reproduced in public acts (2699), or from the date on which other circumstances occur which establish with equal certainty that the writing was drawn up previously."

[4] See previous footnote.

payment of other creditors and, if made in the year preceding the adjudication of bankruptcy, must be repaid. For the purposes of the preceding paragraph financings of shareholders in favour of the company are those howsoever made available at a time when, also in consideration of the business purpose of the company, a large imbalance of the debts as opposed to the net assets existed or where the company was in a financial condition such that a contribution would have been reasonable (s. 2467(2) CC).

Section 2467 CC applies also where a company or entity exercising coordination and direction (the so-called "Guiding Company") of another company (the so-called "Guided Company") operates in its own or in others' entrepreneurial interest in breach of the principles of correct corporate and entrepreneurial management (pursuant to s. 2497 CC).[5]

Comfort letter Comfort letters are usually issued as private deeds. Notwithstanding the wide range of their prospective content (the legal scope of such letters ranges from clearly non-committal language over a legally grey area to letters which come close or are identical to guarantees by the parent company for the respective subsidiary's financial standing and ability to meet its financial obligations at all times), their utility lies in the fact that the parent company issuing such letter does not have to show its commitment, if any, as a contingent liability in its balance sheet.

4. Are there any specific statutory provisions relating to the abovementioned securities, should they be provided for within real estate financing?

S. 38–42 CBA provide for a set of rules applicable to banks granting loans backed by mortgages (so-called "real estate loans" – *credito fondiario*). According to s. 38(1–2) CBA, real estate loans designate medium and long-term loans (i.e. having a duration exceeding 18 months) granted by banks and backed by mortgages on immovable property. The Bank of Italy – in compliance with the resolutions of the Interdepartmental Credit and Savings Committee (*Comitato Interministeriale per il Credito e il Risparmio*) – shall determine the maximum amount of such loans, which shall be defined with reference to the mortgaged property, to the cost of the construction and refurbishment works to be carried out, as well as with reference to already existing mortgages.

[5] The existence of coordination and direction powers (pursuant to sections 2497ff. CC) is presumed, whenever one company either controls or exercises a "dominant influence" over the other pursuant to s. 2359(1–2) CC, according to which "The following are considered controlled companies:

1.) companies in which another company has a majority of the votes exercisable at the ordinary shareholders' meeting;
2.) it holds a sufficient number of voting rights to exercise a dominant influence in the ordinary shareholders' meeting;
3.) it exercises a dominant influence on the basis of contractual arrangements of whatever type.
For the purposes of the application of numbers 1) and 2) of the first subsection the votes pertaining to controlled companies, to fiduciary companies and to an interposed person are also included in the computation: the votes available on behalf of third parties are not included in the computation."

5. Should the answer to the previous question be in the affirmative, what are both the formal and substantive requirements which have to be met for their application? What advantages/ benefits arise therefrom?

Mortgages securing real estate loans shall not be subject to the (bankruptcy) avoidance action,[6] should the debtor be adjudicated bankrupt at a later date, provided the mortgage has been registered in the land register at least ten days prior to the publication of the court decision adjudicating the bankruptcy (see s. 39(4) CBA). Similarly, payments made by the debtor in respect of real estate loans are not subject to the avoidance action (pursuant to s. 39(4) CBA).

A further benefit lies in the fact that the financing bank is entitled to file an action seeking the attachment of the mortgaged property also *after* the borrower's adjudication of bankruptcy. In such cases, the custodian of the attached property, the court-appointed administrator, or the bankruptcy receiver shall pay to the bank any income from the mortgaged properties until satisfaction of the latter's claims, net of any expense for administration and taxes (pursuant to s. 41(3) CBA), notwithstanding the bankruptcy receiver's right to intervene in the enforcement proceedings.

Where the proceeds from the sale of the mortgaged property exceed the quota allotted to the bank, the excess shall be assigned to the bankruptcy proceedings (s. 41(2) CBA).

According to s. 39(5) CBA, upon discharge of each fifth of the original debt, borrowers shall be entitled to a proportional reduction of the mortgage amount. They shall also be entitled to the partial release of one or more mortgaged properties where documents produced or professional valuations establish that the encumbered properties constitute sufficient security for the amount still owed. Bank claims arising from loans with indexing clauses shall be secured by the mortgage up to the total amount effectively owed as a result of the application of such clauses. The adjustment of the mortgage shall be effected automatically where the mortgage registration lays down the indexing clause (s. 39(3) CBA).

6. What liabilities are secured? For what amount? In the case at issue, does the novation of the underlying obligation lead to the maintenance/extinguishment of the securities assisting the original debt?

Mortgage The registration of a mortgage places in the same rank of priority claims related to the expenses for the deed establishing the mortgage, those incurred for the registration and renewal, and the ordinary expenses necessary for joining the enforcement proceedings (pursuant to s. 2855(1) CC). Parties can expressly stipulate that claims for additional judicial expenses be included in the mortgage, provided a corresponding registration is made.

Regardless of the kind of mortgage concerned, the registration of an interest-bearing principal causes the interest thereof to be placed in the same rank of priority, provided that the rate of such interest is mentioned in the registration (s. 2855(2) CC). The extension of the mortgage to the interest is limited to that of the two years prior to and of the year of the attachment, even if an extension to a greater number of years has been agreed upon (s. 2855(2) CC).

[6] The avoidance action in the shape and form described below is known as the so-called "bankruptcy" avoidance action (pursuant to s. 67 BA) as opposed to the "ordinary avoidance action" ruled in the Civil Code (see s. 2901 CC): which entitles a creditor to demand that acts by which the debtor disposes of his/ her assets to the prejudice of a creditor's right be declared ineffective as to the latter.

The registration of the principal causes the interest, matured after expiration of the year in which the attachment occurred, to be placed in the same rank of priority, but solely with reference to the interest at the legal rate and until the date of the public auction of the property by court order.

As far as real estate loans are concerned, banks' claims deriving from so-called indexation clauses also enjoy the same rank of priority (pursuant to s. 39(3) CBA).

Pledge The creditor has the right to be paid with preference out of the proceeds of the sale of the thing received in pledge (see s. 2787 CC). The preference also extends to interest for the year current at the date of attachment or, in the absence of attachment, at the date of notification of the order of payment (*atto di precetto* – pursuant to s. 480 Code of Civil Procedure [hereinafter "CCP"]). Moreover, the preference extends to interest which has subsequently matured, limited to the legal rate, until the date of the sale of the thing given in pledge.

In the case of novation of the underlying obligation, the maintenance/extinguishment of securities assisting the original debt will depend – both with reference to the mortgage and the pledge – on the parties' agreement: as a general rule, privileges, pledges, and mortgages backing the original obligation are extinguished unless the parties do not expressly agree to preserve them (see s. 1232 CC).

7. Is it possible to "divert" such securities (namely, the securities *in rem*) in order for them to act as collateral for other claims, should the original loan agreement be terminated?

No. No such property interest as the German *Grundschuld* exists in Italian Land Law.

8. What rights does a share pledge attribute to the pledgee? Are there any arguments against exercising such rights?

According to s. 2352(1) CC, in the case of pledge or usufruct of shares, the right to vote belongs to the pledgee or the usufructuary, unless otherwise agreed upon. Notwithstanding such attribution of the right to vote, lenders are reluctant to exercise it[7] for fear that such conduct may be classified as *de facto* management (*amministrazione di fatto*) of the borrower and – hence – result in their liability for actions of the borrower.

9. What taxes and levies apply to the establishment of such securities and to their cancellation?

As a matter of principle, any mortgage registration in the land register is subject to a registration tax amounting to 2% of the secured claim (ss. 6ff. Legislative Decree no 347 of 31 October 1990). Similarly, the cancellation of a mortgage is subject to a registration tax amounting to 0.5% of the secured claim.

As far as the establishment of a pledge is concerned, a registration tax amounting to 0.5% of the secured claim will be levied, should the pledge be granted by a person different from the borrower; in contrast, should the borrower provide a pledge, a lump-sum registration tax amounting to €168.00 is applicable.

[7] Namely, with reference to the convening of a shareholders' meeting of the borrower, and to (a) the revocation of existing directors and (b) the appointment of new directors.

Loans with a maturity exceeding 18 months granted by banks and other credit institutions, and any act related thereto, including any security of any kind granted by whomsoever, are not subject to the mortgage tax, to the registration tax, to stamp duties or fees as a substitute tax amounting to 0.25% of the loan amounts due by the lender (see Decree of the President of the Republic no 601 of 29 September 1973).

Loans other than the above are subject to VAT, but are exempt. Therefore, the registration tax applies solely where the relevant deed is a public deed or is deposited with Italian authorities. In any event, the registration tax is levied in a lump-sum amounting to €168.00 (indeed, as a general rule, no registration tax at a proportional rate is applicable to transactions subject to VAT [pursuant to ss 5 and 40 Consolidated Act on Income Taxation – cf. Statute no 917 of 22 December 1986).

10. In the case of *default*, how will the securities *in rem* be enforced?

Mortgage Should lenders intend to have the financed property sold by court order under the mortgage deed:

(a) they must have an "enforcement deed" (*titolo esecutivo*). Italian law classifies – amongst others – public deeds or deeds bearing a signature authenticated by a notary or any other public authority on whom such power has been conferred as an "enforcement deed";
(b) the "enforcement deed" will have to be notified to the borrower together with an order of payment (*atto di precetto* – such notification is not necessary in the case of real estate loans, as s. 41 CBA explicitly waives such formal requirement);[8]
(c) lenders may file a petition seeking the sale of the financed immovable property by notifying an attachment order (*atto di pignoramento*) to the borrower after 10 days but not later than 90 days from the date of the notification of the order of payment (*atto di precetto* – cf. ss. 480–481 CCP);[9]
(d) the competent court first arrange a sale without a public auction (*vendita senza incanto*) of the financed property and will set forth a term falling not earlier than 90 days and not later than 120 days at which anyone, except for the borrower, may submit an offer to purchase the mortgaged property; in the case where more than one offer has been submitted, the competent court will order a bidding process among the offerors to take place (cf. s. 573 CCP);
(e) should no offer be submitted, the court will order that the financed property be sold at a public auction (*vendita con incanto*);
(f) in the event the mortgaged property remains unsold, lenders may request the court to dispose the transfer of the financed property to the lenders to satisfy *pro tanto* their claims towards the borrower.

[8] S. 41 CBA provides for specific rules on attachment of immovable property for real estate loans: indeed, the attachment of the mortgaged immovable property shall be commenced or continued by the bank also after the adjudication of bankruptcy of the borrower. The bankruptcy receiver shall be entitled to intervene in the attachment. The sum recovered following the attachment of the immovable property, exceeding the amount of the bank's claim, shall be attributed to the bankruptcy proceedings.
[9] Should the borrower file an action challenging the formal "correctness" of the enforcement proceedings, an ordinary trial before the competent court would commence and, in case of "serious circumstances" (*gravi motivi*), the enforcement proceedings may be stayed by the competent court.

www.morri-mazza.com

The proceeds of the sale of the mortgaged property, after deduction of the expenses related to the enforcement procedure and the costs for the cancellation of mortgages, will be allocated (a) firstly, in satisfaction of the lenders' claims secured by the mortgage, following an order of priority based on the ranking of the mortgage and (b) secondly, in satisfaction, *pari passu*, of the claims, if any, of unsecured creditors of the borrower.

Pledge In order to enforce a pledge, the pledgee may either pursue the "ordinary" enforcement procedure or the enforcement proceedings peculiar to pledges (pursuant to ss. 2796ff. CC).

In the "ordinary" enforcement proceedings, the pledgee will have to:

(a) notify the "enforcement deed" and the order of payment (*atto di precetto*) to the borrower and to the third party who has given the shares in pledge (should the latter not coincide with the borrower – cf. s. 603 CCP);
(b) not earlier than 10 days but not later than 90 days after notification of the order of payment (*atto di precetto*), the lender may request the competent court to arrange for the sale of the movable property (generally: shares) at a public auction;
(c) the borrower and the third party-pledgor (if any) may raise objections vis-à-vis the lender, challenging the latter's right to foreclose or the compliance with statutory provisions ruling the attachment proceedings. The competent court, may stay the proceedings whenever it deems that "serious circumstances" (*gravi motivi*) exist.

On the contrary, should the pledgee opt for the enforcement of pledges laid down in ss. 2797ff. CC:

(a) he will have to serve a written notice upon the borrower and upon the third party, requesting the payment of the amount due and stating that failure to abide by such request will result in the sale of the shares;
(b) should, within 5 days from the date of receipt of the abovementioned notice, the amount due not have been paid, and should no objection be raised by the borrower and/or the shareholder, the lender is entitled to proceed with the sale of the shares at a public auction;
(c) in case an objection is raised by the borrower and/or the third party, an ordinary trial before the competent court will commence and the proceedings will be stayed.

As an alternative to the sale of the shares at a public auction, lenders are entitled to file a petition before the competent court requesting the transfer of the shares to them (by way of satisfaction *pro tanto* of their claims). In such a case, the court will appoint an expert who will provide an appraisal of the value of the shares.

The "ordinary" procedure may be commenced solely by creditors holding an "enforcement deed" and – as a matter of principle – should be preferred to the procedure laid down under ss. 2797ff. CC, as in the latter procedure any objection filed by the debtor triggers an automatic stay of the enforcement proceedings (whereas in the "ordinary" procedure the competent court will stay the proceedings solely where it deems that "serious reasons" exist).

Acting upon the complaint of the pledgor, the court may limit the sale solely to one thing out of a plurality of pledged things, provided its value appears to be sufficient for the payment of the outstanding debt.

11. Will securities be *automatically* preserved, should the borrower's debt be restructured?

Preliminary remark Generally, securities are preserved until the debt is repaid and the security is formally released. However, a scheme of arrangement may provide for the waiver of securities either on a voluntary basis or as a consequence of a cramdown which would – by definition – also bind dissenting creditors. In such a case, whilst a rearrangement scheme may provide that secured creditors are not satisfied in full, the latter may not be awarded less than they would receive due to their preferential interests (see below with reference to the Judicial Composition with Creditors).

The Italian Bankruptcy Act (see Royal Law Decree no 267 of 16 March 1942 and its most recent amendments[10] – hereinafter "BA"), rules – amongst others – the following schemes of arrangement:

- **(a)** the so-called "validated" Reorganization Plan (*piano attestato di risanamento*) pursuant to s. 67(3) letter (d) BA;
- **(b)** the Restructuring Arrangement (*accordo di ristrutturazione dei debiti*) pursuant to ss. 182-*bis*ff. BA;
- **(c)** the Judicial Composition with Creditors (*concordato preventivo*) pursuant to ss. 160ff. BA.

(a) The "validated" Reorganization Plan (*piano attestato di risanamento*) The *Reorganization Plan* is an out-of-court settlement with single creditors. According to s. 67(3) letter (d) BA, any debtor meeting - in the abstract - the requirements to be adjudicated bankrupt, may draw up a Reorganization Plan indicating how they intend to exit their distressed situation and to comply with their ongoing payment obligations. Should the Reorganization Plan be "validated" by an independent expert, i.e. should the latter confirm its "reasonableness" with reference to the debtor's prospective of overcoming the distressed situation by abiding with such Reorganization Plan assuming full payment of the creditors refusing to accept it, all actions taken in order to implement it may not be challenged by the bankruptcy receiver, should the debtors be adjudicated bankrupt at a later date (pursuant to s. 67(3) letter (d) BA).

Clearly, the "validation" of the Reorganization Plan aims primarily at allowing its implementation, as prospective contractual partners would otherwise – for fear of being exposed to the avoidance action, should the debtor be declared bankrupt at a later date – refrain from entering into agreements provided for therein, i.e. deemed necessary to turn around the distressed business (different from transactions falling in the debtor's ordinary course of business and in accordance with customary terms and conditions including any payment and issuances of securities).[11]

At the same time, it protects dissenting creditors, as – due to the exemption from the avoidance action – the bankruptcy receiver (obviously, in case the debtor were to be adjudicated bankrupt at a later date) would be barred from recovering the debtor's assets with reference to transactions provided for in the "validated" Reorganization Plan.

"Validated" Reorganization Plans are frequently used and preferred over other schemes of arrangement ruled in the BA due to the absence of any court scrutiny, and – hence – to the

---

[10] Cf. Legislative Decree no 5 of 9 January 2006, Legislative Decree no 169 of 12 September 2007, Law Decree no 78 of 31 May 2010, Statute no 134 of 7 August 2012, Statute no 98 of 9 August 2013 and Statute no 9 of 21 Febuary 2014.

[11] Indeed, such transactions would be exempt from the avoidance action pursuant to s. 67(3) letter (a) BA.

www.morri-mazza.com

fact that they may be kept confidential (only listed companies are required to disclose details of the "validated" Reorganization Plan). On the downside, Reorganization Plans – as will be outlined below – do not protect the distressed business from judicial actions brought by (single) creditors.

(b) The Judicial Composition with Creditors (*concordato preventivo*) The Judicial Composition with Creditors is a court-ordered procedure the purpose of which is to prevent the adjudication of bankruptcy through an arrangement between the debtor and its creditors. Any distressed business eligible to be adjudicated bankrupt may apply to the bankruptcy court in order to be admitted to the Judicial Composition with Creditors.

Any kind of arrangement to turnaround the company, also by means of transfer of goods to the creditors and other extraordinary transactions, is admissible.[12] The debtor may also propose a partial payment of secured and/or "preferred" creditors.

According to s. 161(2–3) BA, the petition seeking admission to the Judicial Composition with Creditors will have to encompass the following documents:

- an updated report of the economic and financial situation of the business as well as of its assets;
- a statement of the assets and liabilities of the debtor, of its claims, and of existing "causes of pre-emption", if any;
- a list of any creditors holding property interests or rights in any item owned by the debtor or which the latter possesses;
- the overall value of all assets, and a list of the individual creditors of shareholders having unlimited liability (i.e. in the case of partnership companies), if any;
- a plan which analytically describes the methods and the timing of the implementation of the Judicial Composition with Creditors;
- a report (drafted by an expert appointed by the debtor, in compliance with s. 67(3) letter (d) BA), confirming the veracity of the information provided by the debtor and the feasibility of the proposed Judicial Composition with Creditors;[13]
- the amicable settlement proposal directed at tax authorities, if any (pursuant to s. 182-*ter* BA).

Following the filing of the petition, the court must assess the completeness of the documents submitted by the debtor (see s. 161(2–3) BA).[14] Should the court admit the debtor to the Judicial Composition with Creditors, it will issue an order appointing a Deputy Judge to supervise the proceedings as well as a Judicial Commissioner to administer it (pursuant to s.

[12] For instance, and merely by way of example, the assignment of assets or the transfer of shares or financial instruments to creditors as a means to satisfy their claims is perfectly admissible.

[13] The expert opinion allows both creditors and the court to assess in detail the reliability of the Judicial Composition with Creditors in light of a third party opinion about the debtor's financial position, as well as the available assets on which the arrangement scheme rests.

[14] The distressed debtor may also merely lodge with the bankruptcy court the petition seeking admission to the Judicial Composition with Creditors with the annual accounts of the past three years, without submitting any other document, reserving themselves to file the prescribed documents (see s. 161 BA) within a term which will be fixed by the competent court, and which may vary between 60 and 120 days (pursuant to s. 161(6) BA).

www.morri-mazza.com

163 BA).[15] Furthermore, the competent court will provide that a meeting of creditors shall be convened (which will review and assess the proposed Judicial Composition with Creditors) and will establish a term (of maximum 15 days) within which the debtor shall deposit funds sufficient to (partially) cover the costs of the proceedings. The order granting such admission is published in the companies' register (pursuant to ss. 166 and 17 BA).[16]

On the contrary, should the conditions listed above not be met, the bankruptcy court will not admit the debtor to the Judicial Composition with Creditors and may direct that bankruptcy proceedings be commenced, provided the State Prosecutor or a creditor have filed a corresponding petition (pursuant to s. 162 BA).

For the voting on the arrangement scheme proposed by the debtor within the Judicial Composition with Creditors proceedings, creditors may be sorted into classes, according to their position and uniform economic interests (see s. 160(1) letter (c) BA). Should the debtor make such a division, a different treatment may be granted solely with reference to different classes of creditors (i.e. *par condicio creditorum* will have to be observed between creditors of the same class).

The arrangement scheme underlying the Judicial Composition with Creditors must be approved by creditors representing:

- the majority of claims admitted to vote; and
- if the creditors are divided into different classes (according to their position and uniform economic interests), the majority of classes (see s. 177 BA).

Secured creditors who will be paid "in full" under the proposed arrangement scheme are not admitted to vote, unless they waive wholly or in part their priority rights (see s. 177 BA).

Should the proposed arrangement scheme provide for the partial payment of secured creditors, these will be treated as unsecured creditors in relation to the unpaid portion of their claims (in relation to such portion, they will be entitled to vote).

Once approved, the Judicial Composition with Creditors is binding on all creditors. Therefore, the Judicial Composition with Creditors entails the possibility of a cramdown, both with reference to dissenting (minority) creditors and/or to (majority) creditors belonging to a class rejecting the arrangement scheme, so long as the majority of both claims (by value) and classes of creditors approved it.

In any case, the treatment provided for in the Judicial Composition with Creditors for each class may not have the effect of altering the order of "causes of pre-emption" provided for by law (see s. 160(1-*bis*) BA). In addition, and to the extent that such arrangement schemes were to provide that secured creditors are not satisfied "in full", the latter may in no event receive less than the amount they would be awarded by virtue of their priority

[15] The Judicial Commissioner is – amongst others – under a duty to:
- review the schedule of liabilities and the list of creditors attached to the debtor's petition, taking into
- account the accounting records of the debtor;
- draft a schedule of the debtor's assets;
- give notice to the creditors of the debtor's arrangement scheme and of the date and place set by the court for the creditors' meeting;
- give a full report on the debtor's petition and on the proposed arrangement scheme at the meeting of creditors (see ss 171–175 BA); and
- outline the arrangement scheme submitted by the debtor at the creditors' meeting.

[16] The competent court may also order the publication of the order granting the admission to the Judicial Composition with Creditors in newspapers (pursuant to s. 166 BA).

right (pursuant to s. 160(1-*bis*) BA): to this end, the prospective proceeds from the sale of the debtor's property on which secured creditors have been granted priority rights will have to be appraised (by an expert meeting the requirements laid down in s. 67(3) letter (d) BA).

The preliminary phase ends with the creditors' vote on the proposed arrangement scheme. After acknowledging the creditors' vote in favour of the proposed arrangement scheme, and the absence of any cause of ineffectiveness and/or invalidity, the court "sanctions" the Judicial Composition with Creditors within six months after the debtor's petition was filed with the clerk of the court (pursuant to s. 181 BA). The sanctioning (*omologazione*) of the Judicial Composition with Creditors by the competent court terminates the composition procedure.

(c) The Restructuring Arrangement (*accordo di ristrutturazione dei debiti*) A Restructuring Arrangement is a debtor-in-possession proceeding. The Restructuring Arrangement is an out-of-court relief of financial difficulties, whose purpose is to allow a business to overcome the distressed situation it is in.

Restructuring Arrangements are largely based on freedom of contract, as they essentially amount to an arrangement between the debtor and his creditors which, provided it receives the support of the creditors representing at least 60% of overall claims, will have to be "sanctioned" (*omologato*) by the competent court in order to become effective, i.e. to determine the exemptions laid down in the BA.

Any business in a distressed situation which - in the abstract - meets the requirement to be adjudicated bankrupt may submit a Restructuring Arrangement to it's creditors, together with an expert report assessing the feasibility of the proposed arrangement scheme and confirming the debtor's ability to pay dissenting creditors "in full" within 120 days from the date of the sanctioning of the Restructuring Arrangement by the competent court (if the debt is due on the date of the submission) or from the due date (if the debt is not due on the date of the submission (pursuant to s. 182-*bis*(1) BA)).[17]

The filing of a Restructuring Arrangement with the competent court[18] is published in the companies register. Such publication triggers a 60-day moratorium on any interim relief or enforcement action over the assets of the distressed business in relation to pre-existing debts. In addition, any time limitation and/or forfeiture is suspended, and no priority rights may be granted (pursuant to s. 182-*bis*(3) BA).

In order for the Restructuring Arrangement to be sanctioned by the bankruptcy court, the following requirements have to be met:

- the arrangement scheme has been approved by creditors representing at least 60% of its overall debts; no specific claim-filing procedure exists: it is for the lawyers and/or chartered accountants assisting the debtor to contact the latter's creditors in order to obtain their approval to the Restructuring Arrangement: in any case, no cramdown applies to creditors who disapprove the arrangement scheme;

[17] Similarly to the Judicial Composition with Creditors, the debtor filing a Restructuring Arrangement will have to lodge with the competent court the documents listed in s. 161 BA (pursuant to s. 182-*bis*(1) BA).
[18] The petition seeking the sanctioning of the Restructuring Arrangement will have to be lodged with the court of the place where the company has its "main headquarters": it will be published in the companies register and becomes effective from the date of its publication (pursuant to s. 182-*bis*(2) BA).

- an independent expert confirms the feasibility of the Restructuring Arrangement and the debtor's ability to pay dissenting creditors, with particular reference to the full payment – within 120 days – of creditors refusing to approve the arrangement scheme (pursuant to s. 182-*bis*(1) BA);
- the Restructuring Arrangement has been published in the companies register.

The sanctioning of the Restructuring Arrangement by the bankruptcy court exempts any action taken or payment made by the distressed business in accordance with the Restructuring Arrangement from the avoidance action, should the debtor be adjudicated bankrupt at a later date (see s. 67(3) letter (e) BA).[19]

In an effort to further preserve a business as a going concern, Statute no 122 of 30 July 2010 has provided for the applicability of the moratorium related to any interim relief sought or enforcement action brought by individual creditors also where negotiations with creditors have not yet been finalized (pursuant to s. 182-*bis*(6) BA), provided the debtor files a petition to the competent court which, besides the proposed Restructuring Arrangement, encompasses:

- an updated report of the economic and financial situation of the business and of its assets;
- a statement of the assets and liabilities of the debtor, of its claims, and of existing "causes of pre-emption", if any;
- a list of any creditors holding property interests or personal rights on any item owned by the debtor or which the latter possesses;
- the overall value of all assets, and a list of the individual creditors of shareholders having unlimited liability (i.e. in the case of partnership companies), if any;
- a plan which analytically describes the methods and the timing of the implementation of the proposed Restructuring Arrangement;
- a statement, by the debtor, of the on-going negotiations with creditors aimed at collecting the latters' support to the proposed Restructuring Arrangement;
- a statement by an independent expert confirming the feasibility of the proposed Restructuring Arrangement (if accepted by the creditors) and the debtor's ability to pay creditors who have already expressed their non-approval of the Restructuring Arrangement (pursuant to s. 182-*bis*(6) BA).

The court will assess the completeness of the documents submitted, will order their communication to the creditors, and will fix a hearing within 30 days from the filing of such petition (pursuant to s. 182-*bis*(7) BA). At the hearing, the court will ascertain whether all requirements for the (prospective) sanctioning of the Restructuring Arrangement are met, specifically with reference to the full payment both of dissenting creditors and of creditors with whom negotiations have not yet been finalized (both will have to be paid "in full" – cf. s. 182-*bis*(7) BA). Should the competent court allow such petition, it will grant a moratorium on any interim relief sought or enforcement action brought by individual creditors (such moratorium will have retroactive effects as from the date of the publication of the submission of the petition in the companies register) and on the establishment of priority rights, and will fix a term which may not exceed 60 days for the lodging of both the Restructuring Arrangement and the expert's report confirming its feasibility (see s. 182-*bis*(7) BA).

[19] Within 30 days from the date of its publication in the companies register, any creditor and/or any other interested party may file a complaint objecting to the proposed Restructuring Arrangement (pursuant to s. 182-*bis*(4) BA). The competent court will examine the complaints and take a decision related to such objection, laying down its reasons (pursuant to s. 182-*bis*(4) BA).

12. Are banks entitled to enforce a mortgage directly/through a receiver without having recourse to the competent court?

Banks are not entitled to enforce a mortgage without having recourse to the competent court.

13. What is the average overall duration for the enforcement of a mortgage following enforcement proceedings?

The time necessary to finalize the enforcement proceedings under the mortgage deeds is hardly predictable. According to statistics published by the Bank of Italy, the enforcement proceedings on mortgaged immovable property may easily exceed five years. In order to limit any delaying tactics (for instance, the filing of actions challenging the enforcement proceedings) by the borrower during the enforcement procedure, which would significantly delay the sale of the immovable property, lenders may wish to enforce the mortgage deed after having enforced the pledge and obtained the transfer of the shares (see above under Question 10).

14. Are claims of public/tax authorities granted preferential treatment? Are public/tax authorities able to claim against the property in priority to the first-rank mortgage granted to the lender?

As a general rule, so-called "privileges" grant preferential treatment to certain creditors in view of the source of their claim. The establishment of a privilege may depend on the parties' agreement and may be conditional upon special forms of publicity.

Privileges may be *general* or *special*: the former can be exercised upon all movable property of the debtor; the latter upon the latter's specified movable or immovable property. The CC contains very detailed rules regulating both (a) priority conflicts between "preferred" creditors, i.e. creditors whose claims are assisted by a privilege, and "secured" creditors, i.e. creditors whose claims are assisted either by a pledge or by a mortgage, and (b) the order of priority of claims assisted by a privilege (see ss. 2777ff. CC).

As a basic principle, a *general* privilege cannot be exercised in derogation of third parties' rights on the movable property subject to such privilege (pursuant to s. 2747(1) CC). Unless the law provides otherwise, a privilege on *specified* movable property will prevail over rights acquired by third parties *after* the establishment of such privilege, provided the situation upon which such privilege is conditioned (still) exists (pursuant to s. 2747(2) CC).

Unless the law provides otherwise, a privilege on *specified* movable property may not be exercised in priority over the rights of a pledgee (pursuant to s. 2748(1) CC). On the contrary, unless the law provides otherwise, creditors assisted by a privilege on immovable property enjoy preferential treatment as opposed to mortgage creditors (pursuant to s. 2748(2) CC).

A privilege assisting a claim extends to ordinary costs of (participation in) the enforcement proceedings and to the interest due both for the current year at the time of seizure and for the preceding year. A privilege extends to interest (within the legal rate) subsequently accrued until the time of the forced sale.

With specific reference to the preferential treatment granted to claims of public/tax authorities, the CC provides for a set of privileges (both *general* and *special*) with reference to:

- claims related to the payment of direct taxes, to the payment of the VAT, and to the payment of the income tax due to local bodies (for instance, the income tax of both natural and legal persons as well as the regional tax on productive activities and the local tax on

www.morri-mazza.com

income): such claims enjoy a *general* privilege on the movable property of the debtor (pursuant to s. 2752 CC);

- claims related to the payment of indirect taxes, which enjoy a *special* privilege on the movable property to which such taxes relate and on other property indicated in the pertinent laws, with the effects indicated therein (pursuant to s. 2758 CC);
- claims related to the payment of the income tax of both natural and legal persons, as well as the regional tax on productive activities, and the local tax on income due for the two years preceding the year in which the proceedings are conducted: by way of example, claims related to the tax or the portion of the tax attributable to business income, have a *special* privilege on the movable property used for the operation of commercial enterprises and on the merchandise which is located in the premises used for the operation itself, or in the home of the entrepreneur. The privilege applies even if the property belongs to a person different from the entrepreneur, unless the property has been stolen or lost, the merchandise has been entrusted to the entrepreneur for processing, or in case of goods not yet nationalized having a regular customs bill (see s. 2759 CC);
- claims related to the payment of indirect taxes as well as those deriving from the application of the municipal tax on the increase in the value of immovable property, which have a privilege on the immovable to which they relate (pursuant to s. 2772 CC): such privilege may not be enforced to the prejudice of the rights that third parties have previously acquired on the immovable property (for instance, a bank which has registered a mortgage before such taxes were due). Indeed, s. 2772(4) CC derogates from the general provision under s. 2748(2) CC, according to which creditors whose claims enjoy a privilege on immovable property are preferred to the mortgagee, unless otherwise provided for by law.

Authors

GIACOMO MORRI

Giacomo, Ph.D., is Senior Professor in the Accounting, Control, Corporate Finance and Real Estate Department at SDA Bocconi School of Management, Milan. He is also a Real Estate Finance lecturer at Bocconi University, Milan. Giacomo has been a visiting researcher at Cass Business School, City University London and was a visiting scholar in the Department of Real Estate of the University of Reading. At SDA Bocconi, Giacomo served as Director of the Master in Real Estate and is currently in charge of real estate executive education.

Giacomo has published extensively (both books and articles) on real estate, finance, appraisal, and investment funds. He sits on the editorial boards of the *Journal of European Real Estate Research* and *Territorio Italia* as well as on several scientific and technical committees. In addition Giacomo is a member and assessor of the Royal Institution of Chartered Surveyors (RICS), former president and board member of the European Real Estate Society, and board member of Urban Land Institute – Italy and AICI. Giacomo also sits on the board of several real estate companies.

He is a freelance advisor experienced in investment valuations, property appraisal, property finance, real estate funds, and feasibility studies for real estate projects.

www.giacomomorri.info

ANTONIO MAZZA

Antonio is Teaching Fellow at SDA Bocconi School of Management and a member of the Royal Institution of Chartered Surveyors (RICS).

Following a law degree in 1989, he gained an Executive Master of Business Administration (EMBA) at MIP – School of Management – Politecnico di Milano.

Before working in the real estate market, Antonio gained significant first-hand experience as a practising lawyer in Milan, Brescia, and Como. Antonio has been working for almost 25 years in the real estate market for both Italian and foreign banks (namely Cariplo, Banca Intesa, Barclays Group, DEPFA Deutsche Pfandbriefbank AG, and Aareal Bank AG) and is currently General Manager of Aareal Bank AG Italy and board member of several Italian companies within the "Aareal Group".

www.morri-mazza.com

Antonio has published extensively in national newspapers and first-tier journals and conducts reviews on real estate finance related topics. He has been actively involved in activities aimed at promoting the knowledge of real estate finance on a pro bono basis. He is co-author of *Finanziamento Immobiliare* (Egea, 2010) on property finance.

ALESSANDRO P. SCARSO

Alessandro is Tenured Professor of Civil Law at Bocconi University, Milan. He is also an Attorney at Law and Chartered Accountant in Italy. Alessandro is the author, co-author, and editor of several books, articles, and notes, published both in Italy and abroad.

Alessandro has taught at a number of both Italian and foreign universities (including ESADE Barcelona, FU Berlin, WU Vienna, and the University of Zurich, where he has been co-teaching *Comparative Private Law* at the Faculty of Law since 2011), and is a frequent speaker at national and international conferences.

Besides teaching and research, Alessandro works for Studio Legale PLUTA GmbH in Milan. His expertise covers insolvency, banking, construction, and corporate law. He is a consultant in restructuring arrangements, schemes of arrangement, distressed M&A, and real estate matters (including acquisitions and dispositions, real estate development projects, securitized real estate and other types of financings and loan restructurings and workout).

Alessandro sits on the editorial board of *Responsabilità civile e previdenza* and is co-editor of the *Digest of European Tort Law* – vol. III – "Misconduct" (due to be published in 2016). He is a member of the Italian Society of Construction Law (ISCL), of INSOL Europe, of the Italian Association of Civil Law Scholars (*Associazione Civilisti Italiani*), of the European Centre of Tort and Insurance Law (ECTIL), of the European Law Institute (ELI) as well as founding member of the Chinese European Arbitration Centre (CEAC) and of the World Tort Law Society (WTLS).

References

Altman, E., Resti, A., and Sironi, A. (2004) *Default and Recovery Rates in Credit Risk Modelling: A Review of the Literature and Empirical Evidence*. Economic Notes.

Altman, E., Resti, A., and Sironi, A. (2005) *Loss Given Default: the next Challenge in Credit Risk Management*. Risk Books.

Anson, M. and Hudson-Wilson, S. (2003) Should One Use Leverage in a Private Equity Real Estate Portfolio? *The Journal of Portfolio Management*, Special Issue.

Basel Committee on Banking Supervision (2001) *The New Basel Capital Accord: an explanatory note*. Bank for International Settlements, Basel.

Basel Committee on Banking Supervision (2003a) Consultative Document, *Overview of the New Basel Capital Accord*, Issued for comment by 31 July 2003. Bank for International Settlements, Basel.

Basel Committee on Banking Supervision (2003b) *Overview of the New Basel Capital Accord*. Bank for International Settlements, Basel, p. 5.

Batey, D. L. (1996–1997) *Hidden Costs and Benefits of Mezzanine Level Financing*. North West Venture Group.

Baum, A. E. and Crosby, N. (2008) *Property Investment Appraisal*. Blackwell Publishing, London.

Brounen, D. and Eichholtz, P. M. A. (2001) Capital Structure Theory: Evidence from European property companies. *Real Estate Economics*, 29(4), 615–632.

Brueggeman, W. B. and Fisher, J. D. (2011) *Real Estate Finance and Investments*, 14th edn. McGraw-Hill/Irwin, New York.

Cummings, J. (2010) *Real Estate Finance and Investment Manual*, 9th edn. John Wiley & Sons, New York.

Cummings, J. R. and Epley, D. R. (2013) A National Profile of the Real Estate Industry and the Appraisal Profession, *Appraisal Journal*, 81(2), 129–142.

Della Bella, C. (1996) *I titoli azionari e natura del capitale di rischio*. Egea, Milan, p. 160.

Dewar, J. (2011) *International Project Finance – Law and Practice*, 1st edn. Oxford University Press, New York.

Esty, B.C. and Sesia, A. (2011) *An Overview of Project Finance and Infrastructure Finance*. Harvard Business School – Finance Unit, Boston.

Fabozzi, F. J. (1995) *The Handbook of Mortgage-Backed Securities*. Il Probus Publishing, Chicago.

Fabozzi, F. J. and Dunlevy, J. (2001) *Real Estate-Backed Securities*. John Wiley & Sons, New York.

Fabozzi, F. J. and Nevitt, P. (2000) *Project Financing*. Euromoney Books, London.Fabozzi, F. J., Davis, H. A., and Choudhry, M. (2007) *Introduction to Structured Finance*. John Wiley & Sons, New York.

Feng, Z., Ghosh, C., and Sirmans, C. F. (2007) On the Capital Structure of Real Estate Investment Trusts (REITs). *The Journal of Real Estate Finance and Economics*, 34(1), 81–105.

Forte, J. (2004) *Mezzanine Finance: A Legal Background*. Commercial Securitization for Real Estate Lawyers, Chicago, p. 442.

Forti, D. W. and Stafford, T. A. (2002) Mezzanine Debt: Suggested Standard Form of Intercreditor Agreement. CMBS World, *CRE Finance World*, February.

www.morri-mazza.com

Gatti, S. (2013) *Project Finance in Theory and Practice*, 2nd edn. Academic Press, San Diego.

Geltner, D. M., Miller, N. G., Clayton, J., and Eichholtz, P. (2007) *Commercial Real Estate Analysis and Investments*, 2nd edn. Thomson South-Western, Mason (OH), United States.

Hoesli, M. and Macgregor, B. D. (2000) *Property Investment – Principles and Practice of Portfolio Management*. Pearson Longman, Harlow, UK.

Hoesli, M. and Morri, M. (2010) *Investimento Immobiliare - Mercato, Valutazione, Rischio e Portofoglio*. Hoepli, Milano, Italia.

Hoffman, S. L. (2008) The Law and Business of International Project Finance, 3rd edn. Cambridge University Press, New York.

Hull, J. C. (2012) *Options, Futures and other Derivatives*, 8th edn. Prentice Hall, Upper Saddle River (NJ), United States.

Jensen, M. C. and Meckling, W. H. (1976) Theory of the Firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305–360.

Kahr, J. and Thomsett, M. C. (2005) *Real Estate Market Valuation and Analysis*. John Wiley & Sons, New York.

Kolbe, P. T., Greer, G. E., and Rudner, H. G. (2003) *Real Estate Finance: Theory & Practice*. Dearborn Real Estate.

Lancaster, K. J. (1966) A New Approach to Consumer Theory. *The Journal of Political Economy*, 74(2), 132–157.

Lynch, P. (2011) *Financial Modelling for Project Finance*, 2nd edn. Euromoney Books, London.

Miller, M. H. (1988) The Modigliani-Miller Propositions After Thirty Years. *The Journal of Economic Perspectives*, 2(4), 99–120.

Modigliani, F. and Miller, M. (1958) The Cost of Capital, Corporate Finance, and Theory of Investment. *American Economic Review*, 48(3), 261–297.

Morri, G. and Beretta, C. (2008) The Capital Structure Determinants of REITs. Is it a peculiar industry? *Journal of European Real Estate Research*, 1(1), 6–57.

Morri, G. and Soffietti, F. (2013) Greenbuilding Sustainability and Market Premiums in Italy. *Journal of European Real Estate Research*, 6(3), 303–332.

Morri, G. and Cristanziani, F. (2009) What determines the capital structure of real estate companies? An analysis of the EPRA/NAREIT Europe Index. *Journal of Property Investment & Finance*, 27, 318–372.

Ooi, J. (1999) The Determinants of Capital Structure – Evidence on UK property companies. *Journal of Property Investment & Finance*, 17(5), 464–480.

Reif, A. (2006) *The Regulation on the Determination of the Mortgage Lending Value – Greater Safety in Valuation for Mortgage Purposes*. In Association of German Pfandbrief Banks, Real Estate Banking 2006. Berlin, pp. 41–46.

Resti, A. and Sironi, A. (2007) The Risk-weights in the New Basel Capital Accord: Lessons from bond spreads based on a simple structural model. *Journal of Financial Intermediation*, 16(1), 64–90.

RICS (2012) *RICS Valuation – Professional Standards 2012* (the Red Book), 8th edn. RICS, London.

Rosen, S. (1974) Hedonic Prices and Implicit Markets: Product Differentiation in Pure Competition. *The Journal of Political Economy*, 82(1), 34–55.

Sabarwal, T. (2006) Common Structures of Asset-backed Securities and their Risks. *Corporate Ownership & Control*, 4(1), 1–8.

Scarrett, D. (2010) *Property Valuation: The Five Methods*, 3nd edn. Routledge, Taylor & Francis, London.

Schram, J. F. (2006) *Real Estate Appraisal*, 2nd edn. Rockwell Publishing, Bellevue (WA), United States.

Stone, C. A. and Zissu, A. (2012) *The Securitization Markets Handbook: Structures and Dynamics of Mortgage- and Asset-Backed Securities*, 2nd edn. John Wiley & Sons, New York.

The European Group of Valuers Associations (2009), *European Valuation Standards*, 6th edn. The European Group of Valuers Associations, London.

Vinter, G. D. (1994) *Project Finance, A legal guide*. Sweet & Maxwell, London.

www.morri-mazza.com

Warner, J. B. (1977) Bankruptcy Cost: Some evidence. *Journal of Finance*, 32, 337–347.

Watkins, D. E., Hartzell, D. J., and Egerter, D. A. (2003) Commercial Real Estate Mezzanine Finance: Market opportunities. *Real Estate Issues – American Society of Real Estate Counselors*, 28(3), 34–46.

Willis J. R. and Clark D. A. (1989) An Introduction to Mezzanine Finance and Private Equity. *Journal of Applied Corporate Finance*, 2(2), 77–86.

Wolpert, D. H. and Macready, W. G. (1997) No Free Lunch Theorems for Optimization. *IEEE Transactions on Evolutionary Computation*, 1(1), 67–82.

Yescombe, E. R. (2002) *Principles of Project Finance*. Academic Press, San Diego.

www.morri-mazza.com

Index

www.morri-mazza.com

www.morri-mazza.com

www.morri-mazza.com

www.morri-mazza.com

www.morri-mazza.com

www.morri-mazza.com

Praise for

Property Finance

"When I have to choose a book among hundreds of competing works on the same topic in the bookstores, I usually pay more attention to the reputation and the background of the authors. Giacomo Morri, Antonio Mazza and, as far as the editing of the country reports is concerned, Alessandro P. Scarso finished this book not only on the basis of many years of teaching and research, but also on the basis of their rich experience in the practice on property finance. As a Chinese legal scholar, I personally have benefited greatly from reading this book. I encourage readers to share the valuable knowledge presented in this book."

—Prof. Dr. Junhai Liu, Director, Business Law Center, Renmin University of China, Vice Chairman, China Consumers' Association and Vice Chairman & Secretary General, China Consumers' Protection Law Society

"The authors have filled an urgent need created by the recent global financial crisis and related globalization (and intertwining) of international investment, finance, and real estate sectors: namely, a practical guidebook, useful to the practicing lawyer, business professional and academic alike, on modern international project finance. The authors have done an admirable job of explaining in logical detail the basics of international project finance and common core principles among nations, and the reader is provided with practical case studies and financial models to elucidate the major principles set forth. This book comes highly recommended to anyone seeking a deeper understanding of modern international project finance."

—Paul Varela, Founding partner of Varela, Lee, Metz & Guarino, LLP, Tysons Corner, Virginia - San Francisco, California Recognized as outstanding construction lawyer by Chambers USA, Best Lawyers in America, and Super Lawyers

"Benefiting from many years of research, teaching and professional experience, Giacomo Morri and Antonio Mazza, together with the collaboration of Alessandro P. Scarso, have written an excellent book, covering all the relevant aspects of real estate financing and investing. With seven different country reports, a number of case studies and a friendly writing style, *Property Finance* represents not only an excellent reference for both researchers and practitioners, but also required reading for anyone interested in the financial, legal and regulatory aspects of real estate financing."

—Prof. Andrea Sironi, Rector, Bocconi University

"A valuable contribution to the emerging body of knowledge on global property finance, particularly for its much needed comparative treatment of real estate processes in some of the most important international markets."

—Prof. Dr. Manish Srivastava, Professor of Real Estate Finance & Investments, New York University/ Adjunct Professor of Real Estate Development, Columbia University

"Antonio Mazza and Giacomo Morri, the authors of this book on property finance, solve the perceived dichotomy between real estate practitioners and academia in an ideal way. Mazza and Morri provide a unique property finance textbook that is based on robust economic and finance principles and comparable to those in the area of managerial finance."

—Prof. Dr. Matthias Thomas, Chief Executive Officer, INREV (European Association for Investors in Non-Listed Real Estate Vehicles)

"The authors have adopted an inter-disciplinary approach which successfully pairs the explanation of the core skills required in the field of property finance with the outline of the most relevant legal issues in selected jurisdictions, in the strong awareness that decisions specifically relating to real estate financing cannot occur in isolation from the statutory framework."

—Prof. Giovanni Iudica, President, ESCL (European Society of Construction Law)/ Professor of Civil Law, Bocconi University

Cover Design: Wiley
Cover images reproduced by permission of Shutterstock.com

Subscribe to our free Finance and Investing eNewsletter at wiley.com/enewsletters

Visit wileyfinance.com

BUSINESS AND ECONOMICS

ISBN 978-1-118-76440-4

90000

9 781118 764404

WILEY

Also available as an e-book