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Bank resolution in practice: the banking crisis in Italy

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Summary: 1. The implementation of the BRRD under Italian law. - **2.** The resolution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, Carichieti, and Cassa di Risparmio di Ferrara. - **3.** Financing the resolution (from deposit guarantee schemes to voluntary schemes through resolution funds: sharing the burdens). - **4.** NPL disposal and recapitalizations: financing a (market) solution in order to avoid resolution. Lessons learnt from the experience of Atlante 1 and Atlante 2. - **5.** MPS's precautionary recapitalization: where do we stand?. - **6.** Conclusions.

Section 1

1. Implementing of the BRRD under Italian law

As is well known, the word “bankruptcy” derives from the Italian *banca rotta* which literally means “broken bench”.

> *In Roman times those who traded money (bankers and currency-changers) used to stand before a bench called a mensa argentaria upon which they laid the cash needed for their daily business. The terms “banker” and “bankruptcy” derive from such ancient practice. They subsequently passed into the English language due to the famous bankers from Florence and Siena that were active throughout Europe during the Middle Ages.*
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> *Tuscan bankers, like the ancient Romans, used to set out their money on a wooden bench, hence the name of bankers. If a banker could not meet his obligations, his bench would immediately be broken, which would prevent him from continuing in the banking business: bankruptcy.*

Etymology may be misleading. Despite the origin of the term bankruptcy, Italian banks have never technically gone bankrupt. Instead, as happens in other jurisdictions, Italian banks have been subject to a special administrative regime of bank insolvency that has placed their failure outside the jurisdiction of bankruptcy courts.

1. Implementing of the BRRD under Italian law - *Cont*.

Before the BRRD implementing measures came into force, the Italian legal framework on banking crises was based upon two pre-insolvency and insolvency procedures: special administration (*amministrazione straordinaria*) and compulsory administrative liquidation (*liquidazione coatta amministrativa*). Therefore, even before the BRRD (and the SSM/SRM Regulations) the ordinary bankruptcy procedure (*fallimento*) did not apply to banks.

To some extent, it may be said that under the previous regime (*i.e.* under the Italian Banking Law of 1936 as well as under the Consolidated Banking Act of 1993), Italian supervisory practices already envisaged unwritten “resolution tools” which often relied upon bailouts. Such unwritten tools were used in combination with the administrative insolvency procedures (*amministrazione straordinaria* and *liquidazione coatta amministrativa*).

Under such regime, banking crises were often “resolved” by supporting the sale of the business or the branches of the failing bank to a market participant, generally to a different Italian bank *in bonis*. Thus, the purchasing bank would take on all the assets and liabilities of the failing bank, thereby avoiding “value disruption” and, most important, “ensuring business continuity”, objectives that are now expressly taken into account by the BRRD.

1. Implementing of the BRRD under Italian law - *Cont*.

These old practices ensured full protection to creditors (including all depositors) and were usually financed by the State, which covered the difference in value between the assets and the liabilities taken on by the purchaser (known as “imbalance”, sbilancio). The purpose was not to favour moral hazard, but to protect depositors.

> *From 1974 onwards, public financial support was in many cases provided in accordance with the provisions of a Ministerial Decree (dated 27 September 1974, known as Decreto Sindona), which allowed the Bank of Italy to grant advances for 24 months at a low interest rate (since this was a form of indirect public support it was subsequently prohibited by article 123 TFUE.*

Many things have changed since the 1993 Consolidated Banking Act (*Testo unico bancario*) came into force and then incorporated Directive 19/94/EC (deposit guarantee scheme). Since the late nineties, all Italian banks have been required to be members of a deposit guarantee scheme and to contribute to its funding. The most important Italian scheme is the Interbank Deposit Protection Fund (FITD), a private-law consortium established in 1987 on a voluntary basis, which became the mandatory scheme in 1996 with the implementation of the aforementioned Directive.

1. Implementing of the BRRD under Italian law - *Cont*.

Since the very beginning, in addition to reimbursing depositors, the FITD has also intervened to finance and support the transfer of assets and liabilities of failing banks in compulsory liquidation (*liquidazione coatta amministrativa*) to other market participants. In other cases, it has provided the funding needed by ailing banks under special administration (*amministrazione straordinaria*).

> *Occasionally, in order to deal with the more severe crises, the intervention of the Italian DGS needed to be backed by extra public interventions and ad hoc legislative measures. This was the case of the crisis which hit Banco di Napoli in the Nineties. In order to resolve the crisis, the Italian Government passed Decreto Legge no. 497/1996, article 1 of which authorized the Treasury "to underwrite one or more capital increases […]". Along with the extraordinary public recapitalization, an SPV known as an "SGA" (Società Gestione Attivi s.p.a) was incorporated for the purpose of managing and possibly recovering the depreciated liabilities which we now call "non-performing loans" (NPL). Depriving Banco di Napoli of its NPL made it possible for the Bank of Italy to promote the sale of its (good) business to another market participant (Sanpaolo, subsequently Intesa Sanpaolo).*

1. Implementing of the BRRD under Italian law - *Cont*.

The above mix of written and unwritten rules allowed the Italian supervisory authorities to deal with banking crises and to protect all creditors. This sometimes meant that the taxpayer had to bear the costs of the crisis (in full or in part).

This being the context, it can be argued that the BRRD has introduced tools that were not previously unknown in Italy (*e.g*. asset separation, bad banks, SPVs) alongside brand new provisions, such as the bail-in (the latter being so new that the Italian legislator has not even tried to provide it with an Italian translation).

The main differences between the earlier approach to banking insolvency and the new framework are as follows:

- ✓ the previous regime was based on informal arrangements prompted by the Bank of Italy, but the BRRD has introduced specific and detailed provisions governing processes that were previously carried out on an informal basis. The sale of the business, asset separation and the establishment of bad banks are now tools expressly regulated by a written law: this has superseded the former Italian unwritten “customary law” (*tantum valet consuetudo ubi lex scripta non est*…);
- ✓ the new resolution tools – including the bail-in – are intended to avoid as far as possible public interventions (save for the government financial stabilization tools) in order to protect taxpayers.

1. Implementing of the BRRD under Italian law - *Cont*.

Indeed, in this new world a bank's losses will first be borne by those that have invested in the risk capital (shareholders) and then by those who have financed the bank (creditors, who will bear the loss in accordance with the very particular creditor hierarchy envisaged by EU law).

However, while it is clear that the *internal* recapitalisation of banks is a general solution and will tend to be an alternative to winding up (e.g. *liquidazione coatta amministrativa*), where there is a public interest, resolution may sit alongside the existing insolvency procedures.

The application of the new "tools" does not mean that an ordinary administrative procedure cannot take place *at the same time as* or *in combination with* the resolution procedure, for example in relation to the bank's individual liabilities.

Nonetheless, where a bank is subject to a mixed resolution-winding up procedure, the liabilities subject to resolution (and to bail-in) are undoubtedly excluded from the scope of application of the national rules on failing companies.

In other words, even if the two systems operate together, they necessarily operate on separate parts of the assets: ordinary insolvency rules do not apply to the area of the resolution subject to bail-in.

1. *Implementing of the BRRD under Italian law - Cont.*

This is indirectly confirmed by Decreto Legge no. 183/2015, which resolved the crises of four Italian banks by using both new tools (write-down of claims, bridge institution) and pre-existing tools (compulsory administrative liquidation, winding up). In fact, it required a specific intervention from the legislator to ensure the co-existence of the different measures, which proves that the new system may not always be self-sufficient, i.e. it needs additional detailed rules to operate in the context of an insolvency law which has not yet been adapted to the new ground-breaking tools.

Essentially, this is because the "resolution procedure" is not an insolvency procedure within the strict sense of the term. A full or partial write-down of a bank's liabilities entails the cancellation of certain parties' credit positions with the consequence that they cannot, even in theory, participate in the distribution of any remaining assets. There is no joint participation. There is no (ex ante) par condicio creditorum. The resolution measure cancels the claims of those affected in order to bring forward the final effect of a winding up procedure, but in a different manner which may lead to a different treatment of creditors (even though the latter are entitled to apply for compensation in accordance to the NCWO principle).

2. The resolution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, Carichieti, and Cassa di Risparmio di Ferrara.

In November 2015, the Bank of Italy intervened to resolve the crisis at four banks (the “4 banks”).

These were small or medium-sized banks whose total market share came to about 1% of Italian deposits.

The resolution of the 4 banks followed the transposition of the BRRD into Italian law (Legislative Decree no. 180 of 16 November 2015).

Despite the fact that the bail-in tool only became fully applicable at a later date (on 1 January 2016), the 4 banks underwent a “quasi bail-in” since the resolution actions taken by the Bank of Italy included the immediate write down of equity and subordinated debt holders (on 22 November 2015).

Subsequently, four good/bridge banks were established, whilst the original banks became “residual boxes” incorporating their losses and loss-absorbing instruments.

A single bad bank was also set up with the sole aim of taking on the bad assets of all the original banks.

2. The resolution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, Carichieti, and Cassa di Risparmio di Ferrara. – *Cont*.

In order to reduce the liabilities of the resolved entities, the Bank of Italy wrote-off the share capital and all subordinated liabilities, extinguishing the corresponding administrative and ownership rights. This provided a small contribution to the resolution, which needed to be financed by the *ad hoc* Italian Resolution Fund. The latter provided:

- the equity capital to the bridge banks (3.6 billion euro);
- the financial resources needed by the bad bank.

The Resolution Fund acquired its capital through contributions and facilities made available by the Italian banking sector. In order to keep the "quasi bail-in" to a minimum, and to avoid resorting to state aid, three large Italian banks (Unicredit, Intesa and UBI) provided advances.

As a result, no taxpayers' money was used in the process. The entire cost of the four resolution procedures was borne first by the banks' shareholders and subordinated bondholders and then by the Italian banking system as a whole (through its ordinary and extraordinary contributions to the Italian Resolution Fund).

2. The resolution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, Carichieti, and Cassa di Risparmio di Ferrara. – Cont.

So, where do we stand now?

- *as far as the 4 good/bridge banks are concerned, an Italian bank (UBI Banca) has recently announced a deal to buy three of them. UBI will pay the Italian Resolution Fund the symbolic price of € 1 on the condition that the three banks will first offload 2.2 billion euros of NPLs. Another bank (Banca Popolare dell'Emilia Romagna) is likely to acquire the shares of the fourth resolved bank;*

- *as mentioned, the original banks have become "residual boxes" incorporating their losses and loss-absorbing instruments. They have all been declared officially insolvent and are now in compulsory liquidation;*

- *the NPLs of the 4 banks have been transferred to a special purpose vehicle called REV Spa (the bad bank mentioned above). The transfer decision implied a write down of €8.5 billion of the NPL to €1.5 billion, which required the Italian Resolution Fund to make a capital injection of about €3.7 billion to capitalize REV.*

2. The resolution of Banca Marche, Banca Popolare dell'Etruria e del Lazio, Carichieti, and Cassa di Risparmio di Ferrara. – *Cont.*

This shows that a crisis can be managed in a manner that favours the sale of the business once the burden-sharing principle has been applied. However, the resolution of the four banks attracted media attention because they had issued subordinated bonds which had been bought by, amongst others, retail investors. This gave rise to a difficult debate regarding the need to compensate retail clients who were probably unaware of the risk associated with bank’s bonds, which had for decades prior to the BRRD been widely considered to be “as safe as deposits”.

Consequently, in addition to the funding of the resolution, certain post-resolution financial needs have arisen. I will return to this in the next paragraph.

3. Financing the resolution (from deposit guarantee schemes to voluntary schemes through resolution funds: sharing the burdens).

Was resolution the only viable solution to resolve the crisis of the four banks? One could answer that yes, it was. However, the answer is not that simple.

In the months prior to the transposition of the BRRD, the Italian authorities examined alternative solutions to the crisis of the four banks.

The original idea was to recapitalize them with financial resources belonging to the DGS managed by the Italian Deposit Guarantee Fund (FITD).

However, this plan failed because the DGS's envisaged intervention was considered incompatible with the Commission's rules on state aid. This is due to a strict interpretation of the Banking Communication of 30 July 2013 which considers interventions using mandatory deposit guarantee funds within the "control" of the State, *e.g. the Tercas case. Banca Tercas was a small bank with a market share of about 0.1% of the total banking assets in Italy. In July 2014, the FITD provided the funds needed to cover Tercas's losses and to support its sale to Banca Popolare di Bari.*

3. Financing the resolution (from deposit guarantee schemes to voluntary schemes through resolution funds: sharing the burdens). – *Cont.*

The Commission found that such action was taken by the FITD "on behalf" of the Italian State (in particular, the Commission held that the measure was not in line with state aid rules because Italy did not present a restructuring plan and the measures did not minimise the aid or the resulting distortions of competition).

It is a well-known fact that the Italian authorities and the FITD do not share the Commission's view. Although the Italian Government has obviously complied with the Commission's decision, it has also challenged it before the ECJ, where the Italian Government supports the idea that the FITD's funding comes from the banking system and that, therefore, it is of a private nature. As a matter of fact, the FITD's decision-making process is independent from the State and from the Bank of Italy. Furthermore, the Government appears to support the idea that DGS interventions cannot be automatically considered to be state aid since they are expressly contemplated by the BRRD itself and by the European Directive on deposit guarantee schemes, see Directive 2014/49/EU.

In any case, since the DGS could not be used in the case of the 4 banks which followed the Tercas case, the Italian authorities acted in accordance with the decision of the Commission and established the Italian Resolution Fund in order to fund the resolution of the 4 banks. This prevented the Italian authorities from exempting subordinated bondholders, including retail investors, from the write down.

3. Financing the resolution (from deposit guarantee schemes to voluntary schemes through resolution funds: sharing the burdens). – Cont.

There were only two (theoretical and unviable) alternatives to the failed DGS recapitalization: (i) putting the 4 banks into compulsory administrative liquidation (liquidazione coatta amministrativa); (ii) a voluntary intervention by Italian banks.

The first alternative (liquidazione coatta amministrativa) might have jeopardized financial stability and it would have undoubtedly led to the interruption of critical functions, which would have affected all the creditors and depositors (moreover, it would possibly have been contrary to the public interest).

The second alternative, i.e. a private voluntary intervention, was simply not possible. At the time of the crisis of the 4 banks (November 2015), no specific self-regulated scheme existed. This was established in January 2016, when the FITD created its voluntary intervention scheme in order to support banks in special administration or which were failing or likely to fail, as well as interventions for the transfer of assets and liabilities in the case of compulsory administrative liquidation. Moreover, it has already proven to be an appropriate instrument, since it has already recapitalised a small Italian bank, CariCesena, in June 2016 and provided the facility to resolve the pending issues relating to Banca Tercas

3. Financing the resolution (from deposit guarantee schemes to voluntary schemes through resolution funds: sharing the burdens). – *Cont.*

The Commission's state aid interpretation of the envisaged DGS intervention, the inappropriateness of *liquidazione coatta* and the lack of a voluntary scheme prevented Italian authorities from exempting subordinated retail bondholders from the write down.

It cannot be disputed that investors should be aware that buying subordinated debt implies similar risks to investing in equity. However, it can be argued that if the 4 banks' retail investors had bought debt from Tercas or from CariCesena then they would have not suffered the write down of their bonds.

The risk of loss of confidence, added to this inconsistency, pushed the Government to partially compensate the 4 banks' retail investors. Although their claims had been cancelled by the Bank of Italy under the resolution framework resulting from the transposition of the BRRD, an ex post form of protection has been introduced through Decreto Legge no. 59/2016 for those who bought subordinated bonds before the BRRD came into force. Under the new provisions, retail investors are entitled to file a request for lump-sum compensation to another ad hoc fund (*Fondo di Solidarietà*) created by imposing further contributions on the banking system (the fund, which is different from the mandatory DGS and the voluntary scheme, is nonetheless also managed by the FITD).

3. Financing the resolution (from deposit guarantee schemes to voluntary schemes through resolution funds: sharing the burdens). – *Cont.*

The experience of the 4 banks highlights the risk that by limiting to a minimum the use of public resources (taxpayers' money) a progressively higher level of burden-sharing may be imposed on market participants.

At this point in time, Italian banks are required (either by law or by contract) to pay contributions to:

- the national resolution fund and the Single Resolution Fund. *As a matter of fact, in addition to their main objective of financing resolution actions (e.g. providing capital to bridge banks), resolution funds may be used in post-resolution activities to both: (i) compensate creditors who incurred greater losses than they would have done under normal insolvency proceedings (NCWO); (ii) and to absorb the losses in lieu of the write-down or conversion of liabilities of creditors exempted from bail-in under exceptional circumstances (art. 44, par. 3, BRRD*);
- the Italian DGS, namely the FITD, whose mandate is to guarantee the deposits in the member banks *(and which, according to the Commission, cannot intervene in the financing of the resolution);*
- the voluntary scheme set up by the same FITD, *in which banks representing at least 95% of total covered deposits must participate;*
- the ad hoc fund (Fondo di Solidarietà) created by imposing further contributions on the banking system *(the fund, which is different from the mandatory DGS and from the voluntary scheme, is nonetheless also managed by the FITD).*

3. Financing the resolution (from deposit guarantee schemes to voluntary schemes through resolution funds: sharing the burdens). – *Cont*.

This list shows that in practice, the concept of burden sharing may result in the imposition of very high costs on sound market participants. As a result, the latter may suffer a higher reduction in their profits, which are already low as a result of the long-lasting low interest rates. It is self-evident that, on the one hand, the mandatory contributions may increase the risk of a further banking crisis and that, on the other hand, they may not be sufficient to raise the funding needed to rescue a big bank.

This is probably why other strategies have been put in place over the last months (see the next paragraphs).

Another reason why different strategies are needed relates to the sadly notorious NPL crisis that has affected many Italian banks since the beginning of the financial crisis.

3. Financing the resolution (from deposit guarantee schemes to voluntary schemes through resolution funds: sharing the burdens). – Cont.

On the one hand, the idea of resolving such issues has led the market (supported by the Italian government) to set up a guarantee scheme on NPL securitization (GACS). Alongside this measure, the market has also established private investment funds intended either to provide the necessary capital to ailing banks (Atlante 1) or to purchase the NPLs in order to clean up the balance sheet of selling banks (Atlante 2). Although they are mainly funded by Italian banks, there is nothing to prevent non-banking institutional investors from contributing to the funds.

On the other hand, when a severe crisis involved one of the major Italian banks (Monte dei Paschi di Siena), the Government tried to favour a market recapitalization and, when this failed, it intervened with a public “precautionary recapitalization”. This second case is of the utmost importance because it highlights the fact that resolution funds and voluntary schemes may not be (at least, not yet) ready to absorb the losses of a large bank.

4. NPL disposal and recapitalizations: financing a (market) *solution* in order to avoid *resolution*. Lessons learnt from the experience of Atlante 1 and Atlante 2

4.1 The NPL issue and the GACS framework

According to the IMF (and based on data made available by the Bank of Italy), the ratio of NPLs to total loans in Italy has stretched to unprecedented levels following to the financial crisis: "total NPLs appear to have broadly stabilized at about e356 billion at end-June 2016 (about 18 percent of total loans; 20 percent of GDP; and one-third of the Euro Area total)".

The Italian Authorities have taken several actions to deal with the excessive level of NPLs, including the GACS and the backing of Atlante fund(s).

The GACS scheme (*Garanzia sulla Cartolarizzazione delle Sofferenze*) is a guarantee scheme whose purpose is to facilitate the securitization of bank NPLs. The scheme provides for the granting of State guarantees as part of securitization transactions whose underlying assets are NPLs.

In practice, *Decreto Legge* no. 16/2016 empowers the Treasury to provide an eighteen-month State guarantee on liabilities issued as part of securitization transactions referred to in Article 1 of Law no. 130 of 30 April 1999.

Pursuant to art. 4 of Decreto Legge no. 16/2016, the State-guaranteed securitization must have the following characteristics:

a) the assigned claims are transferred to the SPV for an amount that does not exceed their gross book value (GBV);

b) securitization involves the issuance of securities of at least two different classes differentiated on the basis of their loss-absorbing capacity (junior/senior);

c) the junior class of securities is not entitled to receive reimbursement ifthe more senior tranches are not fully repaid.

The Treasury guarantee – which is expressly defined by the law as irrevocable, unconditional and "upon first demand" – secures the SPV's repayment obligations.

It operates as follows: if the SPV fails to re-pay the amounts due under the senior securities, the holder is entitled to enforce the GACS against the Treasury after a certain period of time and provided that certain conditions are met.

The measure has been heavily negotiated with the European Commission. According to the Italian Ministry, the scheme is compatible with state aid rules because "the price of the guarantee is a market price, as recognised by the European Commission which agrees that the scheme does not envisage any State aid. The price shall be calculated on the basis of single name CDS related to Italian issuers with a risk level equal to that of the guaranteed securities. The price will increase in time, both to cover for the higher risk associated with longer duration of the bonds and to incorporate into the scheme a strong incentive to an early recovery of the credit".

The scheme is already in place. It has been reported by PWC that in October 2016, Banca Popolare di Bari successfully closed the first Italian GACS sponsored securitization. The securitization regarded retail and corporate NPLs for a total value of 480 million euro. The issuer issued three classes of notes (senior, mezzanine and junior) and then filed an application with the Ministry. The latter issued the State guarantee on the senior notes issued in the process (see Ministerial Decree of 25 January 2017).

It has been reported that other operations assisted by the GACS guarantee have been put in place over the last few months.

These include:

- ✓ *one concerning Monte dei Paschi di Siena ("Project Juliet", which alone manages NPLs with a combined gross book value of 9 billion euros);*

- ✓ *another important operation resulting from the Unicredit project accounts as of 31 December 2016. After having approved a capital increase amounting to 13 billion euros, the bank launched a project (named "FINO") consisting of the sale of 17.7 billion euros of NPLs in two phases, through securitization. The plan appears to include "the possible request for a guarantee on securitized loans (GACS) from the Ministry of Economy and Finance (MEF)".*

The question is, therefore, whether the above initiatives are enough to boost a real NPL market. The answer is yet to emerge, but some steps have been taken towards the creation of a "private market for NPLs".

4.2 Atlante 1

There is a compelling need for a market to support the disposal of NPLs from Italian banks' accounts following the national and international evaluation of banks' capital requirements (e.g. ECB Comprehensive assessment).

The asset quality reviews and assessments conducted by supervisors on regulatory capital requirements have highlighted the need for significant capital increases (and the need to reduce the high number of NPLs) with respect to a number of Italian banks.

This is the case of, among others, Banca Popolare di Milano, Banca Carige, Banca Popolare di Vicenza and Veneto Banca. It is worth noting that these banks have undergone a profound legal reform since, on 24 March 2015, the Italian Parliament converted into law a Decreto Legge passed by the Government which amended the regulatory framework applicable to mutual banks (banche popolari). In particular, the reform aims to transform major mutual banks into companies limited by shares (Società per azioni).

While many banks experiencing capital shortfalls have been able to obtain fresh money from the market, two banks from Veneto – a region in the North-east of the country – were not able to do so. Their inability to obtain recapitalization exacerbated their NPL problem from a balance sheet perspective.

Therefore, in addition to the GACS scheme, the Government has tried to favour market solutions by fostering the creation of a fully private investment fund which would intervene in banking crises caused by a large number of NPLs.

Under this framework, on April 2016, an Italian-based management company (*Quaestio Sgr*) established a private alternative investment fund called Atlante 1. Some of the most important Italian banks and financial institutions provided the initial capital for the fund, € 4.25 billion. The purpose of the fund is:

i. to underwrite banks' issued shares which remain unsubscribed in the primary market (in practice: ensuring that the level of capital required by the supervisory authority for banks in crisis is achieved); and

ii. to buy NPLs and property assets from Italian banks (in practice: to clean up their balance sheets, with naturally the chance to apply for a GACS).

4. NPL disposal and recapitalizations: financing a (market) solution in order to avoid resolution. Lessons learnt from the experience of Atlante 1 and Atlante 2. - Cont.

Despite the wide scope of its purpose, a few weeks later, Atlante 1 had to massively underwrite the recapitalizations of the two Venetian banks (Popolare di Vicenza and Veneto Banca), which transformed Atlante 1 into their main shareholder.

The two banks are still struggling to restore their viability and to comply with the reform on mutual banks.

They may need further fresh capital injections and, possibly, an extraordinary precautionary recapitalization guaranteed or underwritten by the State.

Before doing so, however, both the EU and the Italian authorities require the banks to resolve important issues.

The first one is related to the fact that the two banks are under investigation for the alleged mis-selling of their shares to retail investors, which entails a very high legal risk. In order to address this risk, both banks have taken steps to reach a settlement with shareholders and savers. It was reported on 11 April 2017 that the take-up on the offer was around 70 percent, below the target of 80 percent, but enough to reduce the legal risks.

The second issue is related to the envisaged merger between the two banks, which has to be approved by the EU and Italian authorities and that will require a definitive solution to the capital shortfalls of the two entities.

The banks have already submitted a merger plan to the ECB, which includes:

- *a capital increase of 4.5 billion euros;*
- *a request for public precautionary recapitalization (subject to a mandatory conversion of about 1.2 billion euros of subordinated bonds);*
- *recourse to the GACS scheme (possibly with the help of Atlante 2, see below).*

4.3 Atlante 2

The above capital increases provided by Atlante 1 resulted in a significant reduction of its resources, which led to the conclusion that *Quaestio Sgr* should set up a brand new fund (Atlante 2).

Atlante 2 is a closed-end alternative investment fund regulated by Italian law and reserved for professional investors. Its aim is to invest in mezzanine and junior financial instruments, issued by a SPV set up to purchase NPL portfolios from a variety of Italian banks *(according to the data made available by the fund, it can also perform NPL-related deals – e.g. warrants – in order to reduce the risk in line with parameters used by major institutional investors worldwide)*. Therefore, it is intended to benefit from the GACS scheme.

It was set up in August 2016 and collected subscription commitments for Euro 1.715 billion from several Italian financial Institutions (the deadline for subscriptions of the fund is 31 July 2017).

4. NPL disposal and recapitalizations: financing a (market) *solution* in order to avoid *resolution*. Lessons learnt from the experience of Atlante 1 and Atlante 2. - Cont.

In order to give an idea of the potential relevance of NPL investment funds, it is worth noting that in January Quaestio Sgr announced that it had signed a memorandum of understanding on behalf of Atlante 2 according to which the fund aims to purchase 2.2 billion Euro of NPLs held by the 4 resolved good banks Nuova Banche Marche, Nuova Banca dell’Etruria and Nuova Cassa di Risparmio di Chieti.

This highlights the fact that “resolution” is not a panacea for NPLs issues, which have to be addressed through private (where possible) and public initiatives. To this extent, the GACS scheme is certainly a positive legislative action because it is not intended to “rescue” banks, but to foster a private market of securitized potential losses contained in bank balance sheets.

5. MPS's precautionary recapitalization: where do we stand?

5.1 Guarantees on newly issued liabilities and precautionary recapitalization: general measures drawn up on the basis of the MPS crisis.

Public guarantees and precautionary recapitalizations are measures provided by the BRRD (art. 32, par. 4). Under specific circumstances, these measures must be taken in the public interest (*i.e.* in order to remedy a serious disturbance to the economy of a Member State and to preserve financial stability).

This means that where exceptional circumstances occur which require a bank's capital to be strengthened, authorities are allowed to provide extraordinary state aid, but this may only be of a *precautionary* and *temporary* nature. i.e. a State guarantee to back liquidity facilities; a State guarantee of newly issued liabilities; injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution.

Furthermore, the State guarantee or equivalent measures have to be "proportionate to remedy the consequences of the serious disturbance and shall not be used to offset losses that the institution has incurred or is likely to incur in the near future and is permitted as long as the bank is solvent and the intervention is compliant with the rules on State aid".

In this respect, the same BRRD stipulates that a State can only intervene after the subordinated bonds are converted into equity (burden sharing). However, as highlighted by the same Bank of Italy, “*if the subordinated bonds were sold to retail customers without complying with the relevant transparency rules, the impact of the burden sharing principle may be mitigated*”.

The described exceptional circumstance appears to have occurred in the case of Monte dei Paschi di Siena (MPS). At the end of 2016, following the MPS’s failure to obtain a recapitalization from the market, the Italian Government passed a Decreto Legge setting up a national public support procedure designed in accordance with the BRRD rules.

In particular, by means of Decreto Legge no. 237/2016 (converted into Law no. 15/2017), the Government introduced rules intended to avoid the resolution of MPS, the fifth largest bank in Italy, which – if it had failed - would have caused a very serious disturbance to the market, undermining confidence.

5. MPS's precautionary recapitalization: where do we stand? - *Cont.*

The *Decreto Legge* empowers the Treasury to grant public support to Italian banks within the European state aid framework. Moreover, it provides for the creation of a fund with a capitalization of 20 billion euros for 2017 to cover the costs of State guarantees and share purchase and subscription by the Government in order to strengthen the capital of Italian banks.

Although the Decree's immediate purpose is to prevent MPS from triggering a resolution procedure, it is of course applicable to any Italian bank facing a financial crisis.

It consists of two different sections (Titles):

i. Provisions relating to the State guarantee of newly issued liabilities (articles from 1 to 12);
ii. Provisions regulating actions needed to strengthen capital (articles from 13 to 23-bis).

5.2 State guarantee of newly issued liabilities

The first set of rules allows the Treasury to grant a State guarantee on debt issued by Italian banks after 23 December 2016 and until 30 June 2017.

Furthermore, Title I contains rules governing the supply of emergency liquidity assistance (ELA) by the Bank of Italy.

Let us start with the guarantee.

It is clearly intended to improve the banks' ability to raise financial resources on the market: in fact, from a "market perspective", the guarantee represents an inducement for third party investors.

From the point of view of the Italian legislator – and of the guaranteed bank –, the guarantee is an extraordinary tool of a quasi-contractual nature ("quasi-contractual" since the law regulates in detail its issue, fees and characteristics). In addition to market participants, the Treasury and the bank requesting the guarantee, another important role is played by the Commission, which has the ultimate decision on compatibility with state aid rules.

This being the complex framework of the (public and private) parties involved in the scheme, some clarification is needed with regard to the type of instruments involved in the guarantee.

At the request of the issuing bank, the State may issue the guarantee on debt instruments with a remaining duration of not less than three months (or two months, under specific circumstances) and no more than five years (or seven for covered bonds). The guarantee is only applicable to non-complex, non-subordinated, fixed rate debt instruments.

The State guarantee is granted on the basis of a case-by-case assessment by the competent supervisor (i.e. Bank of Italy or ECB). In order to obtain a positive assessment the bank must meet two cumulative conditions: (i) it must be in line with the own funds requirements set out under art. 92 of the CRR; (ii) it must meet the capital requirements as identified by stress testing. Where these conditions are satisfied, the Commission's prior approval is generally required.

5. MPS's precautionary recapitalization: where do we stand? - *Cont*.

Where such conditions are not met (or where they are not cumulatively met), the State guarantee may still be granted to: (i) banks which have a positive net asset value but are nonetheless struggling to obtain urgent liquidity support or (ii) banks under resolution. In these cases, the Decreto Legge requires the Commission's prior approval on a case-by-case basis.

The main characteristics of the guarantee are set out in the Decree: it must be unconditional and irrevocable, issued against a fee and cover principal and interest. This is why it can be described as "quasi-contractual": the main terms of the collateral agreement are provided for in detail by the law, which leaves no room for freedom of contract.

Of course, this is due to the need to comply with state aid rules and the BRRD. However, one might argue that both state aid rules and the BRRD are already applicable provisions of law, so that the Italian Government could have simply applied such provisions without passing a specific and apparently "unnecessary" *Decreto Legge*. However, the *Decreto Legge* presents several advantages.

5. MPS's precautionary recapitalization: where do we stand? - Cont.

Firstly, it clarifies the guarantee framework, which is only generally referred to in the BRRD.

Secondly, it allows the Italian authorities to have talks with the Commission regarding the guarantee scheme prior to approving the text (and this may have helped in getting a green light from Brussels).

Thirdly, it strengthens the decision to issue the guarantee, both from the perspective of the investors that underwrite newly issued liabilities and with regard to judicial claims (if the Italian legislator were to use contractual instruments or secondary legislation, they could be challenged in court: since the State guarantee is envisaged by law, there are very few grounds to challenge the measure).

5.3 Emergency Liquidity Assistance

In addition to the aforementioned guarantee, article 10 of the *Decreto Legge* empowers the Bank of Italy to provide Emergency Liquidity Assistance (ELA). As is well known, under article 2, no. 29, BRRD, ELA means "the provision by a central bank of central bank money, or any other assistance that may lead to an increase in central bank money, to a solvent financial institution, or group of solvent financial institutions, that is facing temporary liquidity problems, without such an operation being part of monetary policy".

In this case, banks requesting ELA must have adequate collateral, to which a valuation haircut is applied based on the quality of the collateral itself. This State guarantee allows the amount of eligible collateral to grow, thereby increasing the possibility for banks to access this form of financing.

The provisions applicable to ELA are similar to those described with respect to the pure State guarantee. In addition, however, banks applying for ELA must present a restructuring plan which demonstrates their capacity to recover and to restore their ability to obtain funding from the market in the long term (when public support is no longer available).

5.4 Capital strengthening measures (precautionary recapitalization).

The second part of the Decree regulates (public) precautionary recapitalization measures. Again, the purpose of the measure is to avoid or remedy a serious disturbance in the economy and to preserve financial stability.

Precautionary recapitalization is a tool which falls within the wider concept of "government financial stabilisation tools" (see articles 37, par. 10 and 56-58 of BRRD). This has been defined as a special government bailout regime [Gortsos].

Under the BRRD, where a public support measure is adopted, the relevant bank is failing or likely to fail and must, therefore, be subject to resolution or liquidated (if the conditions for resolution are not met, e.g.: there is no public interest).

5. MPS's precautionary recapitalization: where do we stand? - Cont.

However, public precautionary recapitalization for the purpose of strengthening capital (without triggering resolution or liquidation) is allowed when a capital shortfall is identified under the adverse scenario of a stress test conducted at national or European level in order to remedy a serious disturbance in the economy and to preserve financial stability. According to the Head of the Directorate General for Financial Supervision and Regulation of the Bank of Italy: "The rationale behind this mechanism is that a bank, even if solvent, may be perceived by the market as being excessively risky under adverse stress conditions, circumstances which could themselves cause a deterioration of the bank's situation and its insolvency. Precautionary recapitalization may therefore resolve cases in which information asymmetries create obstacles to the proper functioning of market mechanisms, generating risks for the individual banks and for financial stability" [Barbagallo].

Although the case is regulated by the BRRD and its national implementing measures, the Italian Government has once again decided to provide more details of the recapitalizion scheme in the Decreto Legge . Accordingly, if such adverse conditions occur, the Italian Treasury "is authorized to purchase shares […] to cover capital deficits of Italian banks" (art. 13, Decreto Legge) identified under "the adverse scenario of a national or European stress test" (article 14, Decreto Legge).

In practice, Italian banks which, based on the result of a stress test, need to enhance their viability by increasing their capital, can submit a plan to the competent supervisor (Bank of Italy or ECB) which aims to strengthen their capital, indicating the measures to be implemented and the relevant timeframe.

Where the plan fails to meet the envisaged capital improvement target, the bank is entitled to ask the Treasury to underwrite (or purchase) its shares. The request must contain specific information and assessments. Any intervention is of course subject to the approval of the Commission: its assessment will be based upon the plan presented by the applicant bank.

Furthermore, State aid rules apply since pursuant to the *Decreto Legge* no shares of the bank may be underwritten and/or purchased by the Treasury without the prior application of the burden sharing principle. . In this respect, the *Decreto Legge* provides *inter alia* for the conversion of different classes of instruments issued by the bank to equity or, alternatively, for the write-down of such instruments and the assignment of newly issued ordinary shares to the holders, with the aim of limiting the use of public funds (the “no creditor worse off” principle applies).

It is worth noting that in addition to the *Decreto Legge* being a general law which is applicable to all banks, article 23 expressly provides for some of MPS's classes of instruments to be converted within this procedure, if MPS submits a request to the MEF for the subscription of its shares.

6. Conclusions

Many different actions have been taken in the last three years. Although the BRRD (and the SSM-SRM package) have introduced a common framework for dealing with banking crisis:

(i) they have not superseded the previous national winding-up procedures (and it might be argued that many principles of the old regime based on the 2001 Reorganisation and winding-up directive are still applicable, see the Portuguese case relating to the re-transfer of certain liabilities from the bridge bank resulting from the resolution of Banco Espirito Santo);

(ii) they have conveniently introduced several exceptions to the fundamental rule according to which no more bail-outs will take place (i.e. taxpayers may still bear the cost of the crisis, the only difference – which is a big difference – is that burden sharing has to be put in place before public funds are used).

6. Conclusions – *Cont.*

This complicates the decision-making process: the banking crisis framework falls within the competence of many authorities (supervisors, EC, national Governments) and provides them with broad discretion as to whether a bank is to be resolved (and how), whether it is to be rescued (and how) and whether it has to be liquidated (and how). In the latter case, moreover, there is no common framework for liquidation and national procedures are still applicable, either alone – if there is no public interest – or in combination with resolution (see section 1).

In this respect, a further issue must be considered. There are potentially conflicting principles in the banking crisis arena. On the one hand, the Commission is responsible for ensuring that no prohibited state aid is supplied to failing banks. On the other hand, state aid may be provided where there is a need to protect the system from a serious disturbance. This assessment concerns the public interest, which must generally be assessed on a national basis (except in the case of large banks), while state aid assessments are always conducted by the Commission, which is a supranational authority.

6. Conclusions – *Cont.*

In the clash between state aid rules and public interest, the decision to favour freedom of competition over depositor (or retail investor) protection may be very controversial. It is not necessarily the case that a strict application of state aid rules will improve the functioning of the market if it causes a wide lack of confidence. From this perspective, the actions taken by Italian authorities in order to avoid, as far as possible, the resolution of banks which have issued subordinated debt to retailers, either by compensating them *ex post* (4 banks) or protecting them *ex ante* (MPS), appears to be in line with the EBA advice and Regulation no. 2016/860 which provide clarification on when it is possible to exclude liabilities from bail-ins.

The common thread that links all the actions that I have attempted to describe is that state aid rules and taxpayers protection are subject to a limit, and this limit appears to be market confidence. Coming back to the first section, one might say that it is right to break the *mensa argentaria* if its creditors are given some hope for the future, if they are not, it is better not to break it.

6. Conclusions – *Cont.*

Another issue that needs to be addressed relates to the residual role of national winding-up procedures. As mentioned, neither the BRRD framework, nor the national laws implemented following the directive (e.g. Decreto Legge no. 237/2016) have repealed them.

Compulsory liquidation (liquidazione coatta amministrativa) still exists. As mentioned, it can be used as an alternative to resolution (as well as to other BRRD tools such as government stabilization schemes) or in combination with other measures. In the case of the 4 banks, it was applied to the four old legal entities – the “empty boxes” – following the transfer of the banks’ businesses to the bridge banks.

Moreover, compulsory liquidation must be used in all cases in which the failing bank does not meet the requirements for resolution, in particular in the absence of public interest. This may imply that compulsory liquidation will apply to non-resolvable and smaller banks while larger banks must, at least in general, be subject to resolution. However, the recent Italian experience demonstrates that there may also be a public interest justifying resolution in the case of small or medium sized banks (4 banks). Furthermore, the MPS case shows that public interest is not necessarily best served by resorting to resolution.

6. Conclusions – *Cont.*

However, whether alone or in combination with other actions, Italian compulsory liquidation will continue to play an important role since – although it is less important than it was in the past – it will apply in many different cases (and is, in fact, applicable to many entities).

A different approach has to be taken as far as special administration (amministrazione straordinaria) is concerned.

First of all, unlike the case of compulsory liquidation (which was and remains the general liquidation procedure applicable to banks), special administration has been profoundly transformed by the implementation of the BRRD.

Prior to the transposition of the directive, special administration was a temporary crisis management procedure applicable to banks in crisis but which had a chance of restoring their financial viability. It could also be applied to sound banks in cases of mismanagement. In order to restore the viability of the bank or to correct management infringements, the Bank of Italy could propose that the Ministry appoint a special director(s) (commissario/i). At the end of the special administration period (in principle, one year, but with the possibility of extension) the Bank of Italy could opt either to put the bank into liquidation or to return it to ordinary administration (depending on the outcome of the special administration). It is no secret that in the overwhelming majority of cases the outcome of the procedure has been liquidation.

6. Conclusions – *Cont.*

Even though amministrazione straordinaria still exists (art. 70, Consolidated Banking Act), the implementation of the BRRD introduced several amendments to the procedure. The first and most important is of a systematic nature: the procedure no longer appears to be considered as a crisis management procedure, but as a supervisory action to be taken in order to avoid a crisis ("early intervention measure"). Therefore, it is now classified as a "super removal" power rather than a winding-up procedure. Moreover, since the BRRD has introduced various early intervention measures, the amended amministrazione straordinaria has now to "compete" with other measures. Clearly, this reduces the likelihood that the Bank of Italy will put a bank into amministrazione straordinaria (and increases the authority's discretion, which can now opt for the different early intervention measures envisaged by article 27 of BRRD, which has been incorporated in the Italian Consolidated Banking Act under articles 69-octiesdecies to 70).