

Testing the EU Framework for the Recovery and Resolution of Banks: the Italian Experience

Stefano Micossi

Abstract

The financial crisis of 2008-09 and the ensuing sovereign debt and banking crises within the Eurozone exposed the presence of a massive moral hazard within the banking systems. They led to a regulatory response that culminated in the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). In order to reduce public support to banks, the Banking Communications and the Bank Recovery and Resolution Directive introduced the burden-sharing and bail-in tools, putting the burden of bank rescue on shareholders and subordinated creditors while minimising the burden on taxpayers. In the light of this general framework, this paper surveys five Italian cases of recovery or resolution of distressed banks during the last five years, to test the flexibility and effectiveness of the EU rules. In Italy, the application of the bail-in was avoided while the application of burden sharing raised specific challenges because of the large amount of subordinated debt held by households. This challenge has been addressed, since the very beginning, by means of compensation tools aiming at remedying specific cases of mis-selling to retail investors. However, while initially this was done under narrow conditions, the broader provisions in the Budget Law for 2019, if resulting in blanket compensation for losses to bondholders (95%) and even to shareholders (30%), would be in clear violation of EU rules.

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1. Introduction

The financial crisis of 2008-09 and the ensuing sovereign debt and banking crises within the Eurozone exposed the presence of massive moral hazard within banking systems. They led to a regulatory response mainly centred on improving the governance and risk management of the banks, reducing regulatory forbearance and taming legal and institutional incentives that had fostered excessive risk-taking. Common rules for the banks in all Member States have been included in a Single Rulebook and specific rules have been adopted for the banks in the euro area. In 2012 the European Council decided to launch the Banking Union project, in order to break the vicious circle between sovereign and bank debts – leading to the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The latter is supported by the directive on the recovery and resolution of banks (BRRD)², to ensure that all the Member States have a legal framework adequate to manage banks' resolution with an administrative procedure, and the establishment of the Single Resolution Fund (SRF). The new system was legislated at record speed by the end of 2013 and entered fully in force at the beginning of 2016.

During the transition to the new regulatory regime, State aid control was used by the European Commission as a coordination instrument at the EU level to maintain a level playing field in the internal market and encourage distressed banks to restructure and return to viability, thus excluding the need for further public support in the future. In particular, the 2013 Banking Communication by

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² Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (BRRD).

the Commission requires, as a condition for the approval of State aid for the recapitalization of banks, burden sharing for shareholders and holders of subordinated debt.³ The BRRD framework includes, among its tools, rules and procedures for the bail-in of private investors (with bank deposits up to 100.000 euros enjoying full protection under national deposit insurance schemes).

The Banking Union is still incomplete as the agreement on its third pillar of supranational deposit insurance has not been reached by the Member States; moreover, the SRF is perhaps too small, and agreement on an adequate last-resort fiscal backstop in case of a systemic banking crisis still looks out of reach. However, one cannot underestimate what has been achieved in setting up a complex and ambitious regulatory framework that has led to a much stronger banking system. The Court of Justice plays a crucial role since, through its interpretation of the new provisions in the light of the EU legal system, it can strengthen and refine the measures and tools designed by legislators.

By now, the legal framework set up in 2013 has been tested in many concrete cases, thus offering the opportunity to evaluate its effectiveness relative to its intended results. This note reviews its application for the management of bank crises in Italy in the last five years. The Italian experience is interesting because of certain conditions existing when the BRRD entered into force – notably the very large amounts of subordinated bonds convertible into shares that had been placed by the banks in retail investors’ portfolios after the explosion of the financial crisis in 2008-09 to recapitalize the banks in very trying capital market conditions. At the end of 2011, households held about euro 35 billion of those junior bonds; in 2013 the new post-crisis rules introduced by the Banking Communication and the BRRD made those bonds “bailinable” to meet bank losses, thus novating their risk characteristics. At the same time, the old system of bank rescues that had always shielded bank creditors from all losses thanks to the intervention of the deposit insurance scheme was challenged by the new interpretation of state aid rules.

³ Communication from the Commission on the application from 1 August 2013 of State aid rules to support measures in favour of banks in the context of the financial crisis (2013 Banking Communication) (2013/C 216/01).

Table 1 -Italian bank bonds held by households (2000-2018)

	Total bonds (bln euro)	in % of households' financial wealth	Subordinated bonds (bln euro)	in % of bonds held by households	in % of households' financial wealth
2000	194	6,3%			
2008	357	9,4%	27	7,6%	0,7%
2009	377	10,0%	30	8,0%	0,8%
2011	372	10,3%	35	9,4%	1,0%
2015	186	4,4%	29	15,6%	0,7%
2018	81	1,9%	14	16,8%	0,3%

Source: Assonime elaborations on Bank of Italy data

Those subordinated bonds by banks in quite a few cases were placed by means of mis-selling practices. In 2017-2018 more than 1200 complaints were raised before the Securities and Financial Ombudsman (ACF) at Consob by holders of subordinated bonds issued by the four Italian banks resolved at the end of 2015 (Banca Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara and Carichieti) and by Veneto Banca and Banca Popolare di Vicenza; 976 of such complaints were deemed admissible and 854 of them were upheld.

Thus, in Italy, repeated bank failures raised with special strength the issue of how to comply with EU rules while at the same time managing their economic and social consequences.

More generally, the BRRD approach whereby the resolution principles applied retroactively to debt instruments already in circulation, rather than only to new issues, is controversial. On the one hand, this retroactive approach is unable to affect the incentives of investors with respect to the financial instruments they already hold; on the other hand, it led to an unexpected increase in the riskiness of household portfolios. By now, the challenge posed to resolution by the large amount of bank debt held by retail investors is acknowledged also by European financial authorities.⁴

⁴ Speech by Andrea Enria, Chairperson of the EBA "Restoring asset quality and building loss absorbing capacity", Milan, 30 November 2017, and Statement of the EBA and ESMA on the

As to burden sharing, the Commission Communication on State aid to banks contains some flexibility clauses, notably in points 19 (burden sharing will be applied provided that “financial stability is not put at risk”) and 45 (there may be exemptions to the application of burden sharing when its consequences would be disproportionate or would endanger financial stability). However, the Commission does not seem very keen to apply those clauses.

On the other hand, the Court of Justice clarified in its decision C-516/14 - *Kotnik*, that the EU Communication is not legally binding on Member States, and that in principle a State aid measure can be declared compatible even if a State does not strictly follow the path outlined in the Communication, provided that the aid is necessary and proportionate to remedy a serious disturbance in the economy of a Member State pursuant to Article 107(3)(b) TFEU. Nonetheless, the probability that a State does not follow the path established by the Commission, risking a negative decision to be challenged before the Court of Justice, remains rather low.

In the light of this general framework, this paper surveys five Italian cases of recovery or resolution of distressed banks during the last five years, to test the flexibility and effectiveness of the EU rules with respect to their general objectives and the availability of instruments to limit the impact of crises on subordinated debt holders. These cases include the Cassa di Risparmio della provincia di Teramo (Tercas), the ‘four banks’ mentioned above, Veneto Banca and Banca Popolare di Vicenza (the ‘Veneto banks’), Monte dei Paschi di Siena (MPS) and Banca Carige.

2. Banca TERCAS

The crisis of Banca Tercas preceded the adoption of the BRRD. Following an approach often used in the past in support of distressed banks, in 2014 the Interbank Deposit Protection Fund (FITD), which is financed by Italian banks, intervened to cover losses and support the acquisition of Banca Tercas by Banca Popolare di Bari.

However, the European Commission considered that the intervention of the FITD amounted to the grant of State aid, arguing that although employing private resources, its interventions were elicited by public institutions; therefore,

treatment of retail holdings of debt financial instruments subject to the Bank Recovery and Resolution Directive, 30 May 2018, (EBA/Op/2018/03).

the Commission ordered the recovery of the aid. Then, the FITD collected additional funds from banks on a voluntary basis ('voluntary intervention scheme of the FITD'), so as to support the distressed bank while avoiding the application of State aid rules and burden sharing.

The approach of the Commission to the assessment of the original FITD intervention was challenged before the European General Court, and the judgment is still pending.⁵ Indeed, there may be purely private reasons which justify a cooperative measure by banks aimed at avoiding a failure which might have systemic consequences. On the other hand, from the point of view of banks participating in the FITD, the need of duplicating allocations (payments to the Fund and payments to the voluntary intervention scheme) appears burdensome and inefficient.

3. The four banks

Banca Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara e Carichieti ('the four banks', with a combined market share of 1% in Italy) had been teetering on the brink of bankruptcy for years. In November 2015 the decision was taken to resolve them in great hurry in order to finalize the resolution before the entry into force of the BRRD, with its new bail-in provisions.⁶

All the conditions for resolution set out in Article 32 of the BRRD were respected. The banks were resolved by transferring their "healthy parts" to bridge banks and by putting their troubled assets in a bad bank. The resolution plans provided for the support of the newly created resolution fund, whose interventions qualify as State aid under EU State aid rules. These plans, which were approved by the European Commission, included the burden sharing for shareholders and subordinated bond holders. Since the application of the bail-in was not yet in force, the resolution did not involve senior bondholders and depositors.⁷

⁵ Case T-98/16 Italy/Commission and T-196/16 Banca Tercas/Commission.

⁶ Exploiting the opportunity provided by the BRRD, legislative decree 180/2015 postponed the entry into force of the bail-in provisions till 1 January 2016.

⁷ http://europa.eu/rapid/press-release_IP-15-6139_en.htm

Compensatory measures for investors holding subordinated instruments of resolved banks were provided, subject to some conditions, by specific legislative measures (see Paragraph 7 below).

4. The two Veneto banks

Veneto Banca and Banca Popolare di Vicenza had repeatedly breached supervisory capital requirements and had been unable to provide the ECB with a credible business plan to ensure recovery and recapitalization. After negotiations lasting several months, the ECB stated that the two banks were “failing or likely to fail”;⁸ a precautionary recapitalization procedure was therefore not applicable.

However, the declaration that a bank is failing or likely to fail is a necessary but not sufficient condition for starting a resolution procedure under EU rules. Pursuant to Article 32 of the BRRD, the resolution procedure may be initiated only when the following three conditions are simultaneously met:

- a. the institution is failing or likely to fail;
- b. there is no reasonable prospect that any alternative private sector measure (including early intervention measures) would prevent its failure within a reasonable timeframe; and
- c. a resolution action is necessary and proportionate, in the public interest, to attain one or more of the resolution objectives, and winding up of the institution under normal insolvency proceedings would not meet those resolution objectives to the same extent.

In this case, the Single Resolution Board (SRB), which is entrusted with the task of assessing whether the third condition (the ‘public interest’ condition) is met, deemed that the application of Italian procedures for an orderly resolution of banks (‘liquidazione coatta amministrativa’) would have been sufficient to attain the objectives of the Directive.⁹ Thus, since the conditions for a resolution action under EU rules were not fulfilled, the bail-in procedure was avoided.

State aid was granted to the two banks in order to facilitate their orderly liquidation and the sale of their worthy assets to Banca Intesa.¹⁰ Thus,

⁸ ECB, press release 23 June 2017,

<https://www.bankingsupervision.europa.eu/press/pr/date/2017/html/ssm.pr170623.en.html>

⁹ <https://srb.europa.eu/en/node/341>

¹⁰ http://europa.eu/rapid/press-release_IP-17-1791_en.htm

shareholders and subordinated debt holders were involved through burden sharing. As in the case of the four banks, legislative measures were adopted opening the possibility for investors, under specific conditions, to obtain restoration of their losses (Paragraph 7).

Some commentators criticised the use of the Italian procedure for administrative liquidation as a circumvention of the European bail-in discipline. However, the BRRD is quite clear in attributing to the European resolution procedure a residual role; furthermore, the assessment of the lack of the conditions for resolution was made at the European level, by the Single Resolution Board.

These developments seem to point to an asymmetry whereby the supervisory powers are fully centralised at the ECB while resolution may follow national legal rules.

As to supervision, in its *Landeskreditbank Baden Wurttemberg* judgment (T-122/17) the General Court stated that the ECB's supervisory competence on a significant bank cannot be challenged by a Member State; significant banks are subject to the ECB exclusive competence and this competence can be decentralised to national authorities only if, in specific circumstances, the supervision by the national authorities is 'more' effective than supervision by the ECB. On the other hand, the wording of Article 32 of the BRRD indicates that, if the objectives of the European resolution system are 'equally' met by national rules, then the conditions for the application of the European resolution procedure are not met.

5. Monte dei Paschi di Siena

In the case of Monte dei Paschi di Siena (MPS) the ECB declared that the bank was not failing or likely to fail and thus was not eligible for resolution. However, although the bank fulfilled the capital requirements under the base scenario of the stress test, the results under the adverse scenario showed that a precautionary recapitalization was needed.

The recapitalization plan, with burden sharing for shareholders and subordinated debt holders, was approved by the Commission under State aid rules, leading to the application of burden sharing.¹¹ As in previous cases,

¹¹ http://europa.eu/rapid/press-release_IP-17-1905_en.htm

legislative provisions set out the conditions for compensation of holders of subordinated bonds.

6. Banca Carige

For Banca Carige, the vast amount of non-performing and bad loans in the balance sheet made the bank vulnerable to a weakening of financial conditions. Despite the application of the FITD voluntary intervention scheme, the bank remained slightly below the supervisory capital requirements, leading the ECB to require a capital increase. When Carige shareholders' meeting did not approve the capital increase, as the majority shareholder abstained from voting, most Board members resigned; the bank was then placed in special administration ('amministrazione straordinaria') by the ECB, under its early intervention powers provided for by the BRRD and enacted into national legislation (*Testo Unico Bancario*, or TUB, Title IV on early intervention measures and compulsory administrative liquidation, Art. 70).¹²

Public funding for the reorganization of the bank was then provided by Decree Law 1/2019 and will have to be assessed by the European Commission under State aid rules. The question under consideration is whether the bank qualifies for precautionary recapitalization. Should the need for burden sharing emerge, there are no subordinated securities issued by Carige in the portfolios of retail holders.

7. Conditions for the compensation of investors

Since 2015 several legislative measures aimed at establishing the conditions under which investors adversely affected by burden sharing can obtain total or partial compensation of their losses.

For holders of subordinated debt issued by the four banks and the two Veneto banks, initially the relevant provisions established that compensation might be obtained from a fund (*Fondo di solidarietà*) fed and managed by the FITD.¹³

¹² ECB, press release 2 January 2019,

<https://www.bankingsupervision.europa.eu/press/pr/date/2019/html/ssm.pr190102.en.html>

¹³ Law 28 December 2015, n. 208, Article 1, co. 855-861; Decree Law 3 May 2016, No 59, converted into Law 30 June 2016, No 119; Decree Law 25 June 2017, No 99, converted into Law 31 July 2017, No 121 (Article 6).

Investors were granted the possibility to obtain either flat compensation (only for households with assets or income not exceeding some thresholds)¹⁴ or compensation through an arbitration procedure at the National Anti-Corruption Authority (ANAC). In the latter case, investors had to prove the mis-selling, i.e. the infringement of the information, diligence and transparency obligations established by the law (the *Testo Unico della Finanza*, or TUF).

In 2018, a new fund (*Fondo di ristoro finanziario*) was set up at the Ministry of Economy and Finance (MEF) with a budget of 25 million euros each year up to 2021, to cover the losses of the “four banks” and the Veneto banks.¹⁵ This fund aims at compensating the banks’ customers who have suffered unfair damages, acknowledged either by a court, the ACF at CONSOB or the Arbitration Chamber at ANAC, in case of mis-selling of financial products, including not only subordinated debt but also shares.

Lastly, the 2019 Budget Law replaced this Fund with the *Fondo indennizzo risparmiatori*¹⁶, again at the MEF, with a budget of 525 million euros a year until 2021. The system applies to investors who “suffered an unfair prejudice by banks and their subsidiaries having legal headquarters in Italy ... because of the massive violations of the information, diligence, correctness, objective good faith and transparency obligations” pursuant to the TUF. For both shareholders and bondholders, the maximum compensation is capped at 100,000 euros, and should not exceed 30% of the purchase cost for shareholders and 95% for bondholders. Compensation is net of other redress and is entrusted to a MEF technical commission. Under this system, thus, the restoration of losses is granted regardless of the conditions of selling, for bonds as well as for shares.

As to Monte dei Paschi, the legislator adopted a different approach, establishing that retail investors (excluding professional clients) whose subordinated bonds had been converted into shares could ask the bank to convert their shares into senior bonds at par.¹⁷

¹⁴ The flat compensation initially reached a percentage of 80% of the purchase price, increased to 95 % by the 2019 Budget law.

¹⁵ Law 27 December 2017, No 205, Article 1, co. 1106-1107.

¹⁶ Law 20 December 2018, n. 145, Article 1, co. 493-507.

¹⁷ Decree Law 23 December 2016, No 237, converted into Law 17 February 2017, No 15 (Article 19, co. 2).

8. Some concluding remarks

The challenge for the application of resolution tools resulting from the large amounts of bank debt held by retail investors makes it clear that the retroactive approach of the BRRD was a hazardous choice. However, looking at the Italian experience with distressed banks in the last five years, the EU framework turns out to be rather flexible and able to deal with different situations.

The application of the bail-in tool in the cases where the banks were failing or likely to fail was avoided either because the relevant provisions were not yet operational in Italy (case of the four banks) or because the SRB decided that the public interest condition for the application of the EU resolution procedure was not met (Veneto banks).

In these cases, as well as for the precautionary recapitalization of MPS, the application of State aid rules has entailed burden sharing for shareholders and holders of subordinated debt. In Italy, the application of burden sharing raised specific challenges because of the large amount of subordinated debt held by households.

This challenge has been addressed, since the very beginning, by means of compensation tools. Compensation of investors, if not properly bounded, could turn out to be a circumvention of the principle of burden sharing, in contrast with European law. However, if it is possible to prove that the investors were victims of mis-selling, compensation is no longer incompatible with EU rules.

This possibility is expressly acknowledged by the DG Comp: “Retail investors should be adequately informed about potential risks when they decide to invest in a financial instrument (as required under the EU Markets in Financial Instruments Directive (MiFID 1) and implemented into national law). If a bank fails to do so, in principle, the responsibility of addressing the consequences of mis-selling lies with the bank itself. Such compensation is an entirely separate consideration to burden-sharing under EU State aid rules. There are different ways to allow retail investors who have been mis-sold to be compensated. This is a decision for the responsible national authorities and/or the bank to take. In situations where banks that have mis-sold financial instruments have left the market, it is up to Member States to decide whether to take exceptional measures

to address social consequences of mis-selling as a matter of social policy. This falls outside the remit of State Aid rules".¹⁸

The open issues are to what extent mis-selling can be presumed in relation to the behaviour of individual banks and to what extent there should be a different treatment of holders of subordinated debt compared to shareholders. In any case, the ex-post compensation approach can only be justified as a solution aimed at remedying specific cases of misconduct. Any blanket restoration of losses is likely to elicit objection from Brussels as it would be in clear violation of the principles set out in the BRRD – which, as it may be recalled, were meant to protect the taxpayers from bank losses.

Annex – Bank bonds held by households in Italy

The amount of bank bonds held by households increased significantly in the first decade of the 2000s, and their weight on the total financial wealth of households went from 6,3% in 2000 to 10% in 2009. Since 2013, the trend has been reversed with a drastic reduction that has brought the weight of bank bonds around 2% of the financial wealth of households at the end of 2018.

Subordinated bank bonds held by households amounted to €27 billion at the end of 2008 (first available figure) and represented 0,7% of their total financial wealth.

Consob official data show that over 20 billion euro of derivative bonds were placed by banks with retail customers in the period July 2007-June 2009, so a large part of the stock was built up in that period and then progressively increased until 2011, remaining around 30 billion euro until the end of 2015. At the end of 2018, the amount of subordinated bonds held by households was reduced to €14 billion (0,3% of financial wealth), but having fallen less than other bank bonds, their weight on the total of financial bonds held by households rose to 16,8%.

Official data from the Bank of Italy show that in September 2018 Italian households held approximately 38% of subordinated bank bonds.¹⁹ This is a very high percentage if compared to that of economies such as France (10%), Spain (less than 30%) and Germany (20%) (ECB data updated to September 2017).

¹⁸ European Commission, Fact sheet "State aid: How the EU rules apply to banks with a capital shortfall", 25 June 2017.

¹⁹ Banca d'Italia, Financial Stability Report, No 2/2018.

Looking at the maturities of the bonds currently in the household portfolio, it emerges that by 2022 more than 7 billion will mature and by 2027 another 5 billion will mature. By 2027, therefore, the stock of subordinated bank bonds currently held by households will be almost exhausted.