Journal of Financial Regulation, 2016, 2, 154–161
doi: 10.1093/jfr/fjw005
Advance Access Publication Date: 12 March 2016
Panorama

OXFORD

The Implementation of the BRRD in Italy and its First Test: Policy Implications

Lorenzo Stanghellini*

ABSTRACT

Eleven months after the deadline, in November 2015, Italy implemented the Bank Recovery and Resolution Directive. The detailed structure of the Directive drove most of the choices, but the Italian implementing acts are overall clearer than the Directive, especially in outlining the sequence of decisions that the competent authorities and the resolution authorities have to take with respect to a bank that is failing or likely to fail. Less than a week after their enactment, the new rules were applied to resolve four regional banks that until then had been under temporary administration. Although the resolution has been carried swiftly and in accordance with the principles of the Directive, this apparently minor case shows two lessons: that almost all banking crises will be handled with the new rules, liquidation being confined to micro-banks, and that the practical challenges of resolution actions are enormous.

KEYWORDS: banks; BRRD; Italy; resolution; bail-in; recovery

BACKGROUND

Several Member States have hesitated to implement the Bank Recovery and Resolution Directive (2014/59/EU, hereinafter 'the Directive') within the short deadline imposed by article 130 of the Directive: 31 December 2014. Italy was among those, and finally transposed the Directive into law in November 2015.

The Directive is extremely long, and its text is very detailed and hard to read. Moreover, it follows a sequence (preparation, early intervention, resolution) that appears logical, but that in reality mixes up instruments of supervision, instruments of resolution and instruments of quasi-resolution. For instance, recovery plans and resolution plans fall under the 'preparation' heading (Title II), but they are two entirely different instruments, and the latter must be read in connection with the resolution tools (Title IV). The write down and conversion of capital instruments tool falls under the 'resolution' heading, but it may be exercised independently of a resolution action, and in such case it does not seem to require 'public interest' as detailed in the Directive (see article 59; see also the following paragraph 4).

* Lorenzo Stanghellini, Professor of Commercial Law, Department of Legal Sciences, University of Florence. The author wishes to thank Iacopo Donati, Carlo Lanfranchi, Monica Marcucci and Andrea Zorzi for useful comments. The usual disclaimers apply.

In fact, the main ambiguity comes from the circumstance that several rules of the Directive are more akin to rules on the supervision of solvent banks, and aim at promoting safe and sound management, albeit with a focus on crisis prevention. Not by chance, such rules are applied by the European Central Bank (ECB) and, at a national level, by the national competent authorities responsible for prudential supervision of banks and certain other financial institutions. For the sake of simplicity, hereinafter we will refer to such banks and financial institutions collectively as 'banks'.

The implementation of the Directive in Italy, albeit faithful to the Directive, has followed a different approach.

THE MAIN CHOICES: (A) THE BANK OF ITALY AS NATIONAL RESOLUTION AUTHORITY

First of all, the Bank of Italy, which shares supervision tasks for Italian banks with the ECB within the Single Supervisory Mechanism (SSM) established by the regulation (EU) no 1024/2013, has also been designated as the Italian national resolution authority.[1] This is allowed by article 3 paragraph 3 of the Directive, under the condition that structural arrangements are put in place that 'ensure operational independence and avoid conflicts of interest'.

The Bank of Italy has been entrusted with the crisis management of banks and financial intermediaries for decades. It is well known that such a concentration of functions has advantages (effective exchange of information between supervisory and resolution functions, smooth operational coordination of the many tasks that the two authorities must perform, especially during a resolution action) and disadvantages (mainly, conflicts of interest between the functions of supervision and resolution, along with excessive concentration of powers).

The Italian Parliament has deemed that the advantages outweigh the disadvantages. Path-dependence and the overall good track record of orderly bank crisis management by the Bank of Italy have obviously played a role in this choice. Accordingly, a special unit has been created within the Bank of Italy, with reporting lines separate from those relating to supervision and to the other functions of the institution.[2] Therefore, since 1 January 2016 the Bank of Italy also shares the resolution powers with the Single Resolution Board (SRB) in Brussels, within the framework of the Single Resolution Mechanism (SRM) created by the regulation (EU) no 806/2014.

THE MAIN CHOICES: (B) TWO SEPARATE SET OF RULES

To implement the detailed provisions of the Directive, two separate Legislative decrees (ie laws enacted by the government pursuant to powers delegated by the Parliament) have been enacted: one for the rules that must be applied by the authorities responsible for the prudential supervision of banks (ie the ECB and, at the national level, the Bank of Italy), and the other for the rules that must be applied by the resolution authorities (the SRB and, at the national level, again the Bank of Italy).

1 Article 8(d), Law 8 July 2015, no 114.
2 The reporting lines rejoin at the level of the governing body ('Direttorio').

Legislative decree 16 November 2015, no 181, amends the existing Consolidated Banking Act (Legislative decree, 1 September 1993, no 385). This important piece of law now includes recovery plans (article 69-ter ff), intra-group financial support (article 69-duodecies ff), and the early intervention measures provided for by article 27ff of the Directive (article 69-octiesdecies ff). With respect to early intervention, the Bank of Italy has the power to require the management body of a bank to implement one or more of the arrangements or measures set out in the recovery plan, the power to remove one or more members of the management and supervision bodies or of the senior management, and the power to demand the complete replacement of the management and supervision bodies. Where replacement of the senior management or management body is deemed to be insufficient to remedy the situation, the Bank of Italy can appoint one or more temporary administrators, either working with the board of directors (article 75-bis) or—more likely—replacing it (article 70ff). It is to be noted that Italy has a long and overall successful experience of temporary administration, which we will briefly discuss below.

Legislative decree 16 November 2015, no 180, in contrast, will stand as the new law on bank resolution. It includes all the rules that must be applied by the resolution authorities (the SRB and, at the national level, the special unit set up within the Bank of Italy). It includes individual and group resolution plans (article 7ff), assessment of resolvability (article 12ff), the powers to address and remove impediments to resolvability (article 14ff) and, in its full procedural complexity and tools, resolution (article 17ff). The bail-in tool is regulated by article 48ff. Most rules, if not all, are the translation of the detailed provisions of the Directive, adapted to the general framework of Italian law. When the SRB, pursuant to article 23, regulation (EU) no 806/2014, will require the Bank of Italy to implement, according to Italian law, a resolution scheme adopted by the same SRB with respect to an Italian bank, it should not receive any bad surprises.

In addition, the Legislative decree 16 November 2015, no 181, has slightly amended the 'liquidazione coatta amministrativa', the special insolvency procedure for banks that is still regulated in the Consolidated Banking Act. The main amendment aims at introducing the depositor preference set forth in article 108 of the Directive. To be noted that Italy has opted for a strong version of depositor preference, one which establishes preference for *any* deposit over unsecured debt, and which will come into force in 2019 (article 91 of the Consolidated Banking Act). After that date, liquidation and resolution will affect depositors (covered and uncovered) only in extreme cases.

Quite significantly, the new law does not contain any provision for extraordinary public support. If and when that is the case, the necessary political decision will be made (possibly through an emergency decree-law), but the message is that public support is not something that is easy to come by. The state of Italian finances would not allow otherwise.

A CLEARER DECISION TREE

As previously anticipated, the structure of Italian law on bank crises appears clearer than the Directive not only with respect to the distinction between 'supervision' and resolution tools, but also with respect to the process that has to be followed to resolve a bank (article 19ff of the Legislative decree no 180/2015). The process set by the Directive and by the regulation (EU) no 806/2014 (the latter for the states of the Eurozone and the other Member States which have joined the SSM in accordance with article 7 of regulation (EU) no 1024/2013) is indeed quite difficult to follow even by specialists. On the other hand, rules that many can understand are easier to apply, and achieving this result was a stated goal of the Italian government in transposing the Directive.

The decision tree is as follows:

(1) the competent authority (ie the ECB or the Bank of Italy), or the same Bank of Italy as resolution authority,[3] can make the determination that a bank is failing or likely to fail; and
(2) the resolution authority then makes the determination that there is no reasonable prospect that any alternative private sector measures or supervisory action taken in respect of the institution, would prevent the failure of the institution within a reasonable timeframe (article 19).[4]

When both conditions are met, the resolution authority:

(3a) executes a 'restorative write down and conversion', if this action alone is sufficient to prevent the bank from failing, ie exercises the power to write down the reserves, the shares (and the other capital instruments included in the Common Equity Tier 1, if any) and the Additional Tier 1 and Tier 2 instruments, up to the point the losses are eliminated, and, subsequently, to convert what is left of those instruments in shares up to the point the desired level of CET1 is reached;[5] or
(3b) if a restorative write down and conversion would not be sufficient, the resolution authority makes a fundamental choice:
(3b1) opens the resolution, when this is a necessary and proportionate measure to protect the public interest as detailed in article 21 (which almost literally transposes article 31 of the Directive: ensuring the continuity of

3 Pursuant to the option allowed by article 32, para 2 of the Directive, the Bank of Italy as resolution authority (ie the separate unit within the Bank of Italy) can also make such a determination.

4 It is to be noted that it is somewhat strange that the resolution authority makes the determination that there is no reasonable prospect that any *supervisory* action (which depends on the initiative of the competent authority) would prevent the failure, but this is explicitly written in the Directive (article 32, para 1(b)).

This sort of paradox is partially solved in SRM reg (EU) 806/2014, which at article 18 states: '. . . An assessment of the condition referred to in point (b) of the first subpara [*ie the lack of alternatives, including supervisory actions*] shall be made by the Board, in its executive session, or, where applicable, by the national resolution authorities, *in close cooperation with the ECB. The ECB may also inform the Board or the national resolution authorities concerned that it considers the condition laid down in that point to be met*' (emphasis added).

5 See article 20, para 1(a), which transposes the principles confusedly emerging from article 32, para 1(b), and article 59, para 3 of the Directive. The write down (up to the point the losses are eliminated) and conversion (up to the desired level of CET1) is done according to the priority ranking deriving from company law and contract (in reverse order, ie the lowest ranking claims being affected first: see article 60, para 1, of the Directive).

critical functions, preserving financial stability, protecting depositors and clients in general, etc.); or

(3b2) opens the ordinary insolvency procedure for banks ('liquidazione coatta amministrativa'), in any other case. As said earlier, this procedure is regulated by the Consolidated Banking Act and is aimed at a quick sale of the assets.

Pursuant to article 23 of Legislative decree no 180/2015, the valuation provided for by article 36 of the Directive, which aims at informing 'the determination of whether the conditions for resolution or the conditions for the write down or conversion of capital instruments are met', is always necessary, *except when* the resolution authority deems that the conditions for either a restorative write down or resolution are manifestly absent, ie it goes directly to point (3b2) of the decision tree outlined above.

This is a debatable choice, but one that seems to come directly from the Directive. In theory, without a proper valuation, the resolution authority could not rule out the possibility that writing down and converting capital instruments suffice to prevent the bank from failing, or the possibility that resolution is necessary in the public interest. In practice, however, this exception may do little harm, given that, as we will see, straight liquidation is probably going to be a rare outcome, and in such case the situation is presumably clear enough.

THE FIRST, HARD TEST

As said above, Italy has a long history of handling bank crises with special rules, rules that have worked well in the past. Temporary administration has been part of bank crisis management for almost a century. It has often been used to guide the bank, after investigating its real condition, either towards a rehabilitation (usually via a share issue or a merger) or towards an orderly liquidation through a going concern sale of the business, to be completed within a weekend in the context of the special 'liquidazione coatta amministrativa' procedure (Banco Ambrosiano in 1982 is a striking example of the second outcome). When the second outcome eventuated, public support or, more recently, deposit guarantee schemes were used to foot the deficit between assets and liabilities (including subordinated debt), so as to make the business (mainly branches) attractive for other banks to buy.

Even without the innovations introduced by the Directive, this pattern could not survive. Today, there are almost no buyers for bank branches (many banks are currently reducing their physical network), and public support is limited by the new, restrictive rules that the European Commission has adopted after the flurry of interventions falling into the category of state aid for banks during the financial crisis.[6] The European Commission requires several conditions for state aid, including burden-sharing by the bank's shareholders and junior capital and debt holders, and—even more important—considers contributions by deposit guarantee schemes to be state aid. On this point, a recent decision of the European Commission has condemned Italy for a contribution by the main deposit guarantee scheme to a

6 Communication 2013/C 216/01 on the application of state aid rules to support measures in favour of banks in the context of the financial crisis <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52013XC0730%2801%29> accessed 12 February 2016.

going-concern sale of an associated bank, even though the contribution was less than the expected cost of the contribution in case of liquidation.[7]

This is why, less than a week after their enactment, the new rules have been immediately tested. In November 2015, four regional banks holding 1 per cent of total Italian deposits were under temporary administration, struggling to find a solution. No buyers were in sight, and a share issue was not feasible without the contribution of the deposit guarantee scheme, which was barred by the likely (indeed, certain) opposition of the European Commission. The political will was strong to solve the problem before 1 January 2016, to avoid four costly bail-ins.

Therefore, on the weekend of Sunday, 22 November 2015:

1. the four banks were put in resolution;
2. four bridge banks were established, each with the same name as the old one except for the word 'New' added before its old name (eg 'Nuova Banca Marche' for 'Banca Marche', and so on);
3. the national resolution fund, established a few days earlier pursuant to article 78ff of the Legislative decree no 180/2015, subscribed for the capital of those four bridge banks;[8]
4. the businesses (branches, assets and liabilities, except subordinated debt) of the four banks were transferred to the respective 'new' bank; and
5. the national resolution fund contributed to the new banks an amount equal to the deficit between assets and transferred liabilities.

The resolution scheme adopted by the Bank of Italy also provided for:

1. the further transfer of the portfolio of non-performing loans of the four new banks to a new asset management vehicle, established by the national resolution fund pursuant to article 45ff of the Legislative decree no 180/2015;
2. the quick sale of the four new entities, as to allow the resolution fund to recover part of the disbursement (this was a condition explicitly imposed by the European Commission to authorize the use of the fund as state aid); and
3. the liquidation of the four insolvent residual entities through the 'liquidazione coatta amministrativa' procedure, which was indeed opened one month later, on 22 December 2015.

Overall, the use of the fund amounts to EUR 3.6 billion (EUR 1.7 billion to subscribe for the shares of the bridge banks, EUR 1.8 billion to cover the negative difference between the assets and liabilities transferred to them, plus various smaller

7 Case SA.39451 Aid to Banca Tercas, decision of 23 December 2015. At the time this article was written the decision was officially announced by the Commission, but is still unpublished as confidential, and its challenge in court appears likely.

8 Effective 1 January 2016, the Italian national resolution fund became part of the Single Resolution Fund, and its resources will progressively merge during the years 2016–23 with those of the other Member States participating to the SRM, pursuant to article 1 of the reg (EU) 806/2014 and the Intergovernmental Agreement on the Single Resolution Fund.

disbursements and costs), plus EUR 0.4 billion of guarantees. Part of it will be recovered through the sale of the bridge banks, but the rest is a cost to the Italian banking system. Added to the cost is the loss for subordinated bondholders, EUR 0.7 billion, and the loss for the shareholders, which is difficult to quantify.

Several coordinated decisions were taken during the weekend by the authorities involved (the Italian Government, the Bank of Italy, the ECB, and the European Commission for the use of the resolution fund as state aid),[9] which was expected but is nonetheless remarkable.

On Monday, 23 November 2015, the four new banks opened regularly their branches. That day, however, far from marking the solution of all problems, proved to be the beginning of the most difficult phase of the crisis. Two of the four banks, and particularly the second in size among them (Banca Etruria), had tens of thousands of shareholders and subordinated bondholders among their customers, clustered in the territory where the banks traditionally operated. Obviously, their savings had been unduly concentrated in the securities of such banks, often with the bank acting in a deep and serious conflict of interest in trying to sell bonds that were necessary for its own survival as a viable entity. At least for the subordinated bonds, however, that was also the consequence of the expectations created by Italian banking history, during which creditors of a bank have never been left unsatisfied, inducing customers to undervalue the real risks.

Infuriated and scared customers started to withdraw deposits from the new banks, putting them under pressure notwithstanding their high capital and liquidity ratios, reducing their value (and, therefore, increasing the losses for the resolution fund) and potentially igniting a wider crisis. The story is developing as we write.

CONCLUSION

Two conclusions can be drawn. First, in the new context almost all bank crises will be handled pursuant to the new rules. The market seems no longer able to reabsorb the assets of failed banks, and even the liquidation of a regional (or sub-regional) bank can have systemic implications, not only on the depositors' side, but also on the borrowers' side: a failed bank will not roll over credit lines, and borrowers cannot easily find other lenders within a short time. Bridge banks, either alone or in connection with a bail-in, seem therefore to have a bright future.

Secondly, resolution itself is a tremendously complex process, but no lesser challenges seem to come *after* resolution. True, the Directive requires the resolution authorities to ensure that a 'fair, prudent and realistic valuation of the assets and liabilities' of the bank is carried out (article 36, paragraph 1), and that the amount of the bail-in is so high as 'to sustain sufficient market confidence in the institution under resolution or the bridge institution and enable it to continue to meet, for at least one year, the conditions for authorization and to continue to carry out the activities for which it is authorized' (article 46, paragraph 2). However, it is one thing to

9 See them at <www.bancaditalia.it/compiti/risoluzione-gestione-crisi/provvedimenti-crisi/index.html> and, for the decision on Banca Marche (the decision on the other three banks are along the same line), <http://europa.eu/rapid/press-release_IP-15-6139_en.htm> (both links accessed on 12 February 2016). The full text of the European Commission's decision was still confidential at the time this article was written.

delude institutional investors, and another to cut into the flesh of customers: that exposes the surviving entity to a fire that may eventually burn it.

In this vein, it may be a sensible policy choice either to *de facto* subordinate senior unsecured bonds to unsecured debt (uncovered deposits and general creditors), like Germany has done,[10] or—which is almost the same—to create a priority for uncovered deposits, like Italy has done (effective in 2019).

Key to a proper functioning of the new rules will be both an appropriate level of minimum requirement of liabilities eligible for bail-in, or MREL (article 45 of the Directive) imposed by the resolution authorities, and, even more important, to ensure that these liabilities are not in the hands of retail investors, or at least not in the hands of *clients*. The years to come will probably be the worst: the transition from bail-out to bail-in[11] has been swift, but the consequent reallocation of bank financing will take time. In the meantime, let us brace ourselves for more use of resolution funds to protect specific categories of creditors, outright public financial support, controversial decisions by the authorities,[12] and for scores of stinging legal challenges.

10 s 46f of the German Banking Act (Kreditwesengesetz, or 'KWG'), revised in September 2015. A previous draft explicitly subordinated senior unsecured bonds, which would come at a cost for their eligibility as collateral for Eurosystem credit operations (see the ECB opinion of 2 September 2015 <https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2015_31_f_sign.pdf> accessed 12 February 2016).

11 P Calello and W Ervin, 'From Bail-out to Bail-in', *The Economist* (28 January 2010) <www.economist.com/node/15392186> accessed 12 February 2016.

12 In a move to shift from retail to institutional investors the further costs of the rescue of Banco Espírito Santo in 2014, apparently done without sufficient public and private resources, on 29 December 2015 Portugal's central bank moved five of 52 senior Novo Banco bond issues to the 'bad bank' it set up to hold the lender's toxic assets after the rescue, therefore, reducing the liabilities of Novo Banco and covering its capital shortfall. See a discussion of the motivation for the move and of the impact on subordinated debt of Italian banks in 'Southern Europe's Banks Feel Cost of Portuguese Actions at Novo Banco', *Financial Times* (17 January 2016) <http://www.ft.com/cms/s/0/93be3c46-bbba-11e5-b151-8e15c9a029fb.html#axzz3xasl9reL> accessed 12 February 2016.