

# Questions and answers on the solution of the crises at the four banks under resolution

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- 19. Is it true that other countries can still avail of state aid while in Italy the small investors have to pay?
- 20. In what way and according to what timeframe will a solution be given to the problems of the banks currently under special administration?

## 1. Was there any delay in placing the banks under special administration?

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The Bank of Italy carries out continuous supervisory action on the basis of the powers delegated to it by law. The conditions necessary to place a bank under special administration are established in the Consolidated Law on Banking (TUB), which makes reference to serious capital losses and/or serious irregularities – only in these circumstances may the Bank of Italy place banks under special administration. The margin of discretion in this decision is very limited. Overly hasty action could lead to a bank being placed under special administration when it is still capable of continuing its activities. In this case, the Bank of Italy would be acting outside the powers granted to it by law.

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## 2. Why was it decided to place the four banks under resolution? Were there no alternative solutions to protect those affected?

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In the months prior to the adoption of the EU's Bank Recovery and Resolution Directive (BRRD), which came into force on 16 November 2015, the Italian authorities examined solutions for the four troubled banks based on the intervention of the Interbank Deposit Protection Fund (FITD), but these were deemed incompatible with the European Commission's rules on State aid. The Commission maintains that any intervention by the FITD qualifies as State aid even though it is entirely financed by the banks, with no public funds involved. If the FITD's intervention had not been considered as State aid, the rescue operation for the four banks by this fund would not have sacrificed the rights of subordinated creditors and the rescue would have assessed the banks' bad debts at book value. Because it is considered to constitute State aid, according to EU law the intervention of the FITD would have forfeited not only the rights of shareholders but also those of the subordinated creditors.

The second alternative was compulsory administrative liquidation. In this case the value of shares and subordinated debt, the last to be repaid in bankruptcy proceedings, would also have been entirely written down, given the extent of the losses. Furthermore, liquidation proceedings, by their very nature, destroy wealth in that they do not aim to conserve assets but

to liquidate them by means of recovery actions or rapid divestment on the market at prices that are necessarily very low. This would almost certainly have also infringed the rights of holders of more senior debt, including unsecured deposits, compromised essential business functions (lending to firms and participation in the payments system) and led to job losses. Ultimately, the losses would have been greater than those suffered under resolution.

The third solution, considered by the European Commission, was a voluntary intervention on the part of Italian banks. As explained below, this intervention was not practicable either.

Considering the existing constraints and regulations, the solution adopted on 22 November, while certainly not painless, minimized the cost of the intervention, safeguarding to the greatest extent possible the rights of depositors and creditors.

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### **3. Why were the four banks saved in November and in this way?**

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Only after the entry into force on 16 November 2015 of Legislative Decree 180/2015, transposing the BRRD into national legislation, was it possible to use some of the tools not previously envisaged under Italian law, such as a 'bridge bank' or a 'bad bank', and above all the Resolution Fund financed by the banks, whose intervention meant that the losses not borne by shareholders and subordinated creditors could be covered. The losses imposed on these classes of investor amounted to about €870 million but further losses of about €1.7 billion were absorbed by the Resolution Fund. This spared many other investors, in particular bond holders and other unsubordinated creditors, from losses they would have suffered if the resolution had been conducted after 1 January 2016 or if the banks had been put into compulsory administrative liquidation.

In the absence of an intervention from the Resolution Fund, financed by the banking system, the cost would therefore have been much greater for creditors and would have affected a much larger number of individuals (investors, employees).

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## 4. Why did the European Commission consider the intervention of the FITD as public and therefore incompatible with the internal market's rules on State aid?

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Among the measures that may constitute State aid, the European Commission's Banking Communication of 30 July 2013 identifies interventions using deposit guarantee funds to reimburse investors to the extent that such use comes within the control of the State and the decision to use the funds is imputable to the State. In particular, in these cases, the Commission requires that (i) any State aid granted to a bank shall be examined and approved by the Commission itself on the basis of the existing procedural rules, and that (ii) shareholders and subordinated creditors shall bear some of the burden of the recovery of the troubled bank through the reduction of the nominal value of their securities or their conversion into equity capital.

As was communicated in the case of the Cassa di Risparmio di Teramo (Tercas), even if the FITD only uses resources provided by the banking system, according to the European Commission, the Fund is fulfilling a public function and therefore its intervention qualifies as State aid. The European Commission – in discussions with the Italian Government – confirmed that the rules on State aid would also have applied in full to interventions by the FITD in the case of the four ailing banks later placed under resolution. This would have led to the application of the burden-sharing principle to shareholders and holders of subordinated debt. Recourse to FITD intervention in the four banks despite the unfavourable opinion of the European Commission could have ultimately led to an obligation on the part of the four banks to repay in full the sums disbursed by the Fund, with the likely introduction of a bail-in during 2016, entailing the reduction and/or conversion of unsubordinated debt.

The Italian authorities maintain instead that FITD intervention cannot be conceived as the kind of State aid prohibited by the European Treaties. In the first place, the resources of the FITD are drawn from the banking system and are therefore of a private nature. Furthermore, the Fund makes independent decisions and other forms of intervention besides the reimbursement of depositors is explicitly contemplated by the European Directive on deposit guarantee schemes (Directive 2014/49/EU).

In any event, it was decided to utilize the Resolution Fund because burden-sharing was only made possible following the transposition of the BRRD, which identifies the Resolution Fund as one of the tools to be used to achieve the resolution goals; it was not possible to use the FITD because, again according to the BRRD, its use is prohibited for interventions in favour of banks under resolution except to reimburse protected depositors.

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## 5. Why didn't the banking system intervene voluntarily for these four banks as they have now done for the Cassa di Risparmio di Teramo (Tercas)?

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The FITD began to create a scheme – to run in parallel with the obligatory one – open to the 'voluntary' participation of the banks, in order to resolve the Tercas case ex post. Work on its establishment began on 22 November 2015 and ended on 25 January 2016. The scheme is endowed with €3 billion for interventions, roughly equal to the amount already transferred from the FITD to Tercas and which must now be repaid to the FITD as a result of the requirements of the European Commission's decision. For the four banks subsequently placed under resolution, the banking system was unable to gather sufficient consensus within its ranks to attempt this solution.

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## 6. Why were the shares and the subordinated bonds of the four banks written off and not reduced in value or converted into shares of the new banks?

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On the basis of the BRRD and Italian legislation, in the case of a resolution procedure the amount of the reduction in value and the possible conversion of subordinated bonds into shares of the bank are not decisions at the discretion of the Resolution Authority but are related to the extent of the losses, as determined by the precise procedures and evaluation criteria established by the BRRD.

According to the rules:

- The Resolution Authority must, first and foremost, reduce the value of the shares and subordinated bonds to cover the bank's losses; of course, if the losses exceed their total value, the shares and subordinated bonds will be written off entirely;
- Only when the value of the losses is less than that of the shares and subordinated bonds does the Resolution Authority first reduce the value of the shares and subordinated bonds to the extent necessary to cover the losses and then convert the residual value of the subordinated bonds into shares of the bank (whilst ensuring compliance with any prudential requirements). In the case of the four banks placed under resolution in November, the losses of each bank were greater than the value of the shares and subordinated bonds; for this reason the total value of the shares and subordinated bonds was wiped out and further losses covered by the Resolution Fund.

## 7. What is the difference between burden-sharing and a bail-in?

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The legislation in force until the end of 2015 made provision for burden-sharing: if a bank collapsed, it was expected that before involving public funds the nominal value of the shares and subordinated bonds would be reduced (or converted into equity capital).

From 1 January 2016 bail-in provisions are in force which, before the involvement of the Resolution Fund (or more generally of public funds), requires the reduction of the nominal value of not only shares and subordinated bonds, but also of more senior debt securities, such as ordinary bonds and deposits of more than €100,000. A bail-in must respect insolvency rankings: consequently it is applied first to shares, then to other equity and subordinated debt, and then to unsecured debts, including ordinary bonds issued by the bank in difficulty. Deposits of €100,000 or less are always excluded from a bail-in and are covered by deposit guarantee schemes; deposits over this amount can only be bailed in for the amount in excess of the €100,000 threshold and, if held by individuals or small or medium-sized enterprises, only if all the other liabilities subject to the bail-in are insufficient but, if held by other counterparties, are considered as unsecured debt and therefore assimilated with ordinary bonds in the ranking. In any case, from 1 January 2019, deposits above the €100,000 threshold will also benefit from preferential treatment and will be bailed in only after ordinary bonds and other unsecured debts (but in any case, before the deposits in excess of €100,000 held by individuals and small or medium-sized enterprises).

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## 8. Is it true that the BRRD contravenes Article 47 of the Italian Constitution by damaging investors who, at the time of purchase of the subordinated bonds, could not have been aware of the risks inherent in these instruments?

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It must first be emphasized that the losses incurred under the resolution were no greater than those the subordinated creditors would have suffered under compulsory administrative liquidation.

Regarding the applicability of the bail-in instruments already available, as established by the Directive and the rules for its transposition under Legislative Decree 180/2015, any assessments of unconstitutionality must of course be examined by the Constitutional Court.

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## 9. How did the Bank of Italy identify which bad debts had to be transferred to the bad bank?

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The bad debts to be transferred under the resolution provisions are those which, already in the special administration phase, had been entered in the balance sheet as such.

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## 10. Is it true that during the resolution the Bank of Italy applied punitive criteria for assessing the bad debts of the four banks (reducing their average nominal value by some 18 per cent)? Had the rate of devaluation been less severe could shareholders and subordinated bondholders have been spared?

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The assessment of bad debts for the purposes of resolution must be made in accordance with the criteria laid down by the BRRD, but also with the indications on state aid rules given in the *Communication from the Commission on the treatment of impaired assets in the Community banking sector* of 25 February 2009 (2009/C 72/01). This assessment diverged from that used in routine accounting practice. In discussions held in the days immediately prior to the resolution, the Commission clearly indicated that the only acceptable solution, which approximated the theoretical value of the loans' immediate disposal, was to value collateralized debt at 25 per cent of the amount disbursed and uncollateralized debt at 8 per cent. The Commission referred to this in its press release of 22 November 2015.

The rules on State aid and the BRRD provide that in the event of resolution all the initial losses are borne by shareholders and, immediately afterwards, by subordinated bondholders. Accordingly, even if the assessment of the bad debts had been less severe, the Resolution Fund would have benefited in that it would have had to cover a lower amount of losses. Given the size of the losses, however, the situation for shareholders and subordinated bondholders would have nevertheless remained unchanged.

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## **11. How many subordinated bondholders are there now at the four banks? What is the overall share of subordinated bonds relative to the entire banking system?**

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There were some 10,500 subordinated bondholders at the four banks, for a total value of €789 million; almost half of this sum was invested in institutional or professional portfolios. Based on the data available at the end of October, the total amount of subordinated bonds issued by Italian banks came to €67 billion. Net of the securities repurchased by the issuing banks, the subordinated bonds in circulation equalled €59 billion, of which €31 billion held by retail investors.

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## **12. Why did the Bank of Italy fail to prohibit the sale of risky instruments to unsophisticated investors?**

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The law does not grant the Bank of Italy the power to ban the sale of the instruments covered by the resolution measures. From 3 January 2017, with the transposition of the revised Markets in Financial Instruments Directive (MiFID2) and Regulation (MiFIR), the Bank of Italy will be able to ban the sale of financial products for financial stability purposes only, while Consob remains competent for all matters pertaining to investor protection.

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## **13. How can investors ensure they are adequately informed about the risks stemming from the new rules on crisis management and accordingly make informed decisions (especially in relation to a bail-in)? What responsibilities does the Bank of Italy have for overseeing the issuance of instruments potentially subject to losses in the event of a bank collapse?**

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Pursuant to the Consolidated Law on Finance the placement of bank bonds, including subordinated bonds, constitutes the direct placement of banking financial products (if carried out by the issuing bank) or of investment services (if provided by intermediaries other than the issuing bank). In both cases the provisions on investor protection of the Consolidated Law on



Finance apply and, in particular, the obligations of due diligence, fairness and transparency vis-à-vis investors in Articles 21 and 23 of the Consolidated Law on Finance and Consob's Regulation on Intermediaries, transposing Directive 2004/39EC (MiFID). According to these provisions, the obligations of the intermediary include that of acquiring all the information needed for providing the service (i.e. customers' knowledge of and experience in the investment sector, their financial situation and investment objectives), as well as ensuring that the investor is always well-informed. The collection of this information plays a fundamental role in the entire process: in fact, based on the data gathered, the intermediary proceeds to draw up a profile of customers in order to identify the investments best suited to their characteristics. If the intermediary deems that the investment is not suited to the customer's needs, the customer must be informed. However, there is no ban on carrying out the operation as part of a placement of financial instruments (unlike what happens for portfolio management and consultancy services). Another safeguard for investors is the obligation, in the event of a public offering or subscription of financial products (including of bank and even subordinate bonds), to publish a prospectus informing investors of the characteristics of the products offered (Articles 93-bis and seq. of the TUF).

In accordance with the provisions of the TUF, controls on compliance with this set of rules by the banks and other intermediaries fall within the exclusive competence of Consob. Without a specific request by the latter, the Bank of Italy cannot, on its own initiative, make checks on compliance with provisions on investor protection. However, bearing in mind the distribution of supervisory tasks between the two Authorities as envisaged by the TUF (sound and prudent management of intermediaries for the Bank of Italy, investor protection for Consob) the Bank of Italy nonetheless:

- can examine investor protection issues at the specific request of Consob (precisely for this reason the Bank of Italy notifies the launch of its own inspections, so that Consob may then request targeted inspections);
- informs Consob whenever these investigations reveal information of potential interest to Consob itself (possible irregularities that emerge during routine verifications and not specific targeted inquiries which, as was pointed out earlier, would be precluded unless requested by Consob).

Without prejudice to Consob's specific sphere of competence, the Bank of Italy has conducted intensive financial education on the potential impact of the transposition of the BRRD on bank bondholders. Following the issuance of an enabling law, the Bank of Italy's website published the document referred to below, illustrating the changes deriving from the new system for managing bank crises and possible repercussions for investors

<http://www.bancaditalia.it/media/approfondimenti/2015/gestione-crisi-bancarie/index.html>.

A meeting with consumer associations was also held recently, to identify ways of increasing investor awareness on these issues; in the past few months both the Governor and other members of the Governing Board have utilized several public occasions (including hearings at the Chamber of Deputies and the Senate) to underscore the importance of the question, also

suggesting the possibility of introducing in the future specific legal constraints on the placement of instruments that could be subject to a bail-in, so as to curb their placement with less sophisticated retail investors and channel them towards professional investors.

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## **14. The four banks' problems mostly stem from loans disbursed and never recovered. Why doesn't the Bank of Italy publish the results of its own health checks of banks and the list of borrowers that have received funding but have failed to pay it back?**

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This is prohibited by law. The information in the Bank of Italy's possession acquired in the course of its supervisory, regulatory and inspectorial activities cannot be divulged owing to the limits imposed by the obligation of professional secrecy pursuant to Article 7 of the Consolidated Law on Banking, according to which 'all the information and figures possessed by the Bank of Italy by virtue of its supervisory activity shall be covered by professional secrecy, also with respect to governmental authorities...'. Similar constraints are, moreover, imposed by European legislation (EU Council Regulation No. 1024/2013). The violation of professional secrecy by a staff member of the Bank of Italy can also lead to criminal proceedings. The professional secrecy obligation does not apply in a number of clearly circumscribed cases (for example vis-à-vis the judiciary and Consob).

Of course, like all other private enterprises, banks can encounter temporary problems of various kinds. The problems of many ailing banks have been resolved over the years without the Bank of Italy making it public, in compliance with the legislation on professional secrecy. Given the supervisory action and inspections carried out, the Bank of Italy has published all the information that can be divulged (for example, the sanctions imposed on management) in accordance with the limits set by the professional secrecy law. In all cases of suspected misappropriation, the Bank of Italy has provided timely information to the judiciary.

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## **15. Why did the crises of recent months emerge only after the arrival of European supervision?**

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This is not the case. It is worth recalling that national supervision is part of European supervision: the Single Supervisory Mechanism (SSM) is based on close cooperation between the ECB and the national supervisory authorities (NSAs). During the initial phase of operations, the ECB and NSAs have jointly addressed problems that arose at individual banks in various

countries and within the banking system as a whole. Considerable effort was made to introduce a single supervisory system capable of guaranteeing equal treatment of intermediaries. The on-site inspections that uncovered episodes of malfeasance at Italian banks were conducted by groups of inspectors entirely or primarily made up of Bank of Italy staff members.

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## **16. How does the imposition of sanctions on the banks' management work?**

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Sanction proceedings are governed by law (in particular, Article 145 of the Consolidated Law on Banking and Laws 689/1981, 241/1990 and 262/2005) and by the Bank of Italy's implementing measures and they are imposed according to a step-by-step procedure. If, in the course of its supervisory activity, the Bank of Italy identifies irregularities punishable by administrative sanctions, it formally notifies the charges to the persons deemed responsible and opens a sanction procedure. This upholds the principle of adversarial proceedings, access to the investigative acts and separation of the investigative and decision-making stages; the recipients of the notification can present to the Bank of Italy written counter-arguments and request individual hearings, as well as access to documents. At the end of the investigative phase, once all the facts have been ascertained, the defences presented, and all available evidence examined, the inspectors submit the proposed sanctions to the Governing Board of the Bank of Italy for its evaluation; having consulted with the Bank of Italy's General Counsel, the Board decides collectively, adopting a reasoned decision.

Notification of the sanction measure is given to the parties concerned and published on the Bank of Italy's website.

The notified parties must pay the sanction within thirty days of its notification. Appeals against the sanction measure can be made within the deadlines and according to the conditions provided by law.

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## **17. What proceedings have been taken or will be taken against the former managers responsible for the collapse of the four banks?**

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The Bank of Italy has started sanction proceedings against all the bank executives charged with administrative irregularities; it also promptly transmitted to the law enforcement authorities, at the time in which they were identified, all potentially noteworthy observations that emerged in the course of the supervisory activity.

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## 18. Is it true that the Bank of Italy 'backed' the merger of Banca Popolare dell'Etruria with Banca Popolare di Vicenza?

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No. The Bank of Italy is tasked with authorizing requests for mergers between banks on the basis of criteria established by law, designed to ensure that the newly established bank can be managed in a sound and prudent manner. In the case of Banca Popolare dell'Etruria-Banca Popolare di Vicenza the proposed merger was independently mooted by Banca Popolare di Vicenza. The Bank of Italy, as is its custom, examined the arguments put forward on both sides in order to rapidly form an opinion prior to a possible request for authorization. But the talks stalled because the parties failed to reach an agreement and there was no formal request for authorization.

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## 19. Is it true that other countries can still avail of state aid while in Italy the small investors have to pay?

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Prior to the adoption of the European Commission's 2013 Banking Communication on the application of State aid rules to banks (*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*), several European countries had disbursed very substantial sums in state aid to national financial systems since at that time Community legislation imposed fewer constraints on these interventions. More recently, the Commission permitted an intervention by the German Deposit Protection Fund as part of the rescue of a German bank since the initial intervention was made before the entry into force of the Communication.

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## 20. In what way and according to what timeframe will a solution be given to the problems of the banks currently under special administration?

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As of today there are three banks under special administration. Excluding the Credito Sportivo, a public entity, the other two are extremely small mutual banks, for which solutions capable of fully protecting creditors are currently being studied.

KEYWORDS

 Banks

 Banking crises

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