Italy – Capital Injections (2008)

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February 5, 2020

Abstract

In response to the 2007-2009 global financial crisis, in October 2008, the Italian government announced urgent measures to guarantee financial stability and the flow of credit. The Italian government targeted three areas of support: a) bank recapitalizations, b) liquidity access, and c) expansion of guarantees on bank deposits. This case exclusively examines the Italian bank recapitalization scheme introduced in December 2009 in line with EU State aid rules.

The four Italian banks recapitalized in 2009 under the scheme were Banco Popolare (€1.45 billion), Banca Popolare di Milano (€500 million), Credito Valtellinese (€200 million), and Banca Montepaschi di Siena (€1.9 billion), for an overall amount of €4.05 billion. The government purchased special bonds issued by banks. These bonds became known as "Tremonti bonds" and Italian regulators agreed to treat them as core Tier 1 regulatory capital.

Keywords: Italy, banks, recapitalization, capital injections, financial crisis, Tremonti bonds

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Capital Injections – Italy (2008)

At a Glance

The 2007-2009 global financial crisis prompted governments around the world to take unprecedented actions. On October 9, 2008, the Italian government issued Decree-Law 155, on urgent measures to guarantee the stability of the financial system and the continued flow of credit. It targeted three areas of support: bank recapitalizations, greater access to liquidity, and expanded guarantees on bank deposits. Decree-Law 185/2008 became the legal basis of the Italian bank recapitalization scheme.

The Italian Ministry of Economy and Finance recapitalized four banks in 2009 by the purchase of special bonds, known as "Tremonti bonds," to strengthen the banks' balance sheets. Despite speculations, the two largest Italian banks Intesa San Paolo and Unicredit did not participate in the scheme.

Italian regulators deemed the Tremonti bonds as core Tier 1 regulatory capital because they were perpetual, non-cumulative, and convertible into common shares after three years. Participating banks had to adhere to a "code of ethics" regarding policies on executive compensation. They had to commit to increase lending to small and medium-sized enterprises (SMEs), contribute to the guarantee fund for loans granted to SMEs, suspend up to 12 months of mortgage payments for homeowners, and ensure appropriate liquidity levels to creditors of public administrations.

Summary of Key Terms	
Purpose: "to restore stability of the financial system and to remedy a serious disturbance in the economy of Italy"	
Announcement Date	October 9, 2008
Legal Authority	Italian Decree-Law 185/2008; EC Treaty Article 87 (3)(b)
Date of first capital injection	July 31, 2009
Last Date to inject capital	December 31, 2009
Program Size	Initially, available funds were up to €15-€20 billion. In February 2009, up to €12 billion.
Participants	Banco Popolare (€1.45 B), Banca Popolare di Milano (€0.5 B), Credito Valtellinese (€0.2 B), Banca Montepaschi di Siena (€1.9 B)
Usage	€4.05 billion
Administrators	Italian Ministry of Economy and Finance
Outcomes	
Notable features	"Tremonti bonds," code of ethics, commitments to lend to SMEs.

Summary Evaluation

Italian authorities expressed that the Italian recapitalization scheme "exhibited satisfactory performance in its implementation, providing a safety net that corresponds well to market needs and ensuring the provision of lending to the real economy." In February 2010, Bank of Italy's governor Mario Draghi expressed that Italian banks were "well placed to cope with the international environment." Draghi noted that their capital bases were strengthened by the issue of shares, disposal of non-core assets, the ploughing back of profits and, in some cases, government interventions.

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I. Overview

Background

The collapse of Lehman Brothers in mid-September 2008, and the ensuing global financial crisis, triggered unprecedented responses from governments around the world. In October 2008, in a period of ten days, multiple high-level government meetings took place in efforts to coordinate an international response and common measures to combat the crisis. The meetings included the European Council on Economic and Financial Affairs (ECOFIN) on October 7, 2008; the G7 summit in Washington D.C. on October 10; an emergency Euro summit of heads of state on October 12; and the European Council meeting on October 15-16.

The ECOFIN approved a set of principles and extraordinary measures for European governments to combat the crisis (ECOFIN 2008). The G7 finance ministers and central bank governors pledged to take aggressive actions that included: support for systemically important financial institutions, all necessary efforts to ensure credit access to banks, temporary guarantees on short and medium-term liabilities, expansion of guarantees on bank deposits, bank recapitalization through the use of public funds, and acquisition of illiquid assets (G7 2008).

The Euro heads of state released the "Declaration on a concerted European action plan of the Euro area countries" which committed efforts to reestablish confidence and the well-functioning of the financial system. In agreement with the European Commission (EC) and the European Central Bank (ECB), the plan outlined support to financial institutions by facilitating: a) appropriate liquidity conditions, b) funding of banks, c) additional capital resources, d) recapitalizations of distressed banks, e) flexibility in the implementation of accounting rules, and f) cooperation among European countries (Euro Summit 2008). A few days later, the European Council endorsed the plan of action and extended it to all countries part of the European Union (Euro Council 2008).

Italy, on October 9, 2008, issued Decree Law N. 155, "Urgent measures to guarantee the stability of the credit system and the continued flow of credit to firms and consumers in the current state of crisis in world financial markets." The decree envisaged a government package focused on three areas of support to the Italian banking sector: a) bank recapitalizations, b) access to liquidity, and c) expanded guarantees on bank deposits (Bank of Italy 2008, 21). This case exclusively examines the Italian bank recapitalization scheme.

At the time, Italy held a large and increasing public debt (estimated at 105% of GDP in 2008). Italian banks' interest rate spreads over Italian government bonds had widened significantly in the past year. The head of the Italian Ministry of Economy and Finance (MEF) Giulio Tremonti expressed that Italy, unlike other European countries, could not pursue a major fiscal stimulus through deficits or debt increases. However, Tremonti remained confident that the Italian financial system was in better condition than other European countries, as

Italian banks relied on more traditional credit activities such as retail deposits and bonds, and less on complex securities such as in the US or the UK (The Economist 2009).

The reported aggregate Tier 1 capital ratio of the Italian banking system was 7.7% in 2007 and 7.6% in 2008. For the five largest Italian banks, it was 6.4% in 2007 and 6.7% in 2008 (see Table 1).

Table 1: Italian Banks - Capital Ratios in 2007 and 2008

Capital adequacy of Italian banks and banking groups (1)
(end-of period data in millions of euros)

	Banking system		Main groups (2)	
	2007	2008	2007	2008
Allocations to regulatory capital	10,804	10,893	6,841	8,025
Regulatory capital	201,721	204,639	122,672	122,441
Core tier 1 capital ratio (%)	7.2	7.0	5.7	5.8
Tier 1 capital ratio (%)	7.7	7.6	6.4	6.7
Total capital ratio (%)	10.4	10.8	9.5	10.4
Leverage (3) (4)	20	22	25	27
Excess capital	47,550	54,916	19,912	28,857

(1) Consolidated data for banking groups and individual data for banks not belonging to a group. Excludes the Italian branches of foreign banks. – (2) Five largest groups by total assets as of December 2008 – (3) Ratio of total balance sheet assets to tier 1 capital. – (4) Provisional data.

Source: (Bank of Italy 2010, 154)

Program Description

The legal bases for the Italian government support package were passed through fast-track procedure as Decree-Law N. 155/2008 on October 9, Decree-Law N. 157/2008 on October 13, and Decree-Law N. 185/2008 on November 29. These were converted into Law N. 190/2008 on December 4, and Law N. 2/2009 on January 28 (Bank of Italy 2009c, 170).

On November 20, 2008, the ECB published a recommendation on the pricing of bank recapitalizations by national governments. The EC released guidance on December 5 to ensure that recapitalizations through EU State aid did not grant banks undue competitive advantages and financial stability was preserved in line with the rules of the single market. The EC guidance envisioned two types of recapitalizations: for "distressed" banks and for "fundamentally sound" banks. In principle, recapitalizations for distressed banks required stricter requirements (Bank of Italy 2009a, 9; EC 2008a; ECB 2008). For sound banks, recapitalization allowed governments to acquire securities issued by the banks with an "appropriate" yield of between 7% and 9%. Higher yields could be considered in order to encourage banks to buy back the securities as market conditions improved (Bank of Italy 2009a, 9).

The legal basis for the Italian recapitalization scheme for sound banks was Article 12 of Decree-Law 185/2008, converted into Law N. 2/2009 (Bank of Italy 2009c, 170–71; EC 2009c). The total available funds for the Italian recapitalization scheme was unspecified but expected to be between €15 and €20 billion (EC 2008b). Italian authorities made clear that support would be available "as needed"(Bank of Italy 2009d, 25). In February 2009, when the scheme was amended, the size of the scheme was reported to be up to €12 billion (Reuters 2009a). The €80 billion Italian economic stimulus plan announced on November 15, 2008, was considered low at an estimated 0.6% of GDP (Financial Times 2008; Bank of Italy 2009d, 5).

Italy notified the EC of its recapitalization scheme on December 18, 2008, which the EC approved on December 23, 2008, after intensive exchanges with Italian officials. The scheme was in line with EU State aid rules, as a temporary measure and compatible with Article 87 (3)(b) intended to "restore stability of the financial system and to remedy a serious disturbance in the economy of Italy" (EC 2008b; 2008c).

The MEF was empowered to recapitalize banks until December 31, 2009, conditional on a notification to the EC after six months on the need to prolong the scheme. Eligible institutions included fundamentally sound Italian banks (including subsidiaries of foreign banks) with shares listed on regulated markets. The criteria of fundamentally sound was based on a bank's credit default swaps spread, ratings, and a complementary assessment by the Bank of Italy. The Bank of Italy assessed the bank's solvency, capital adequacy, and risk profile (EC 2008c; 2009c; Bank of Italy 2009c, 170–71).

The scheme was expected to have its first operations by January 2009. However, in the first two months of the scheme, no bank participated. Then, in February 2009, the scheme was amended to offer a second option of remuneration. This was intended to make it more attractive to banks who expected to use the government capital for a short period of time. It consisted of higher annual coupons in exchange of lower redemption prices for the first four years, which were set at nominal value. (EC 2009a). On February 16, 2009, Italy notified the EC of the amendment, which as approved on February 22, 2009. Three days later, Tremonti signed a ministerial decree to allow the government to recapitalize banks by buying "special bonds" from banks, considered as core Tier 1 regulatory capital (EC 2009b). These bonds became known as "Tremonti bonds."

Italian regulators treated the Tremonti bonds core Tier 1 capital because they were perpetual and convertible into common shares after three years. The interest paid was non-cumulative—only paid when a bank had distributable earnings, provided that the bank's capital ratio was at least 8%. Remuneration included an initial coupon with fixed step-up clauses, increases in remuneration associated with dividend payments and financing costs of the government, and a redemption price premium that increased over time. Individual recapitalizations were limited to 2% of a bank's risk weighted assets, without surpassing 8% of Tier 1 capital ratio (Bank of Italy 2009b, 40–42; EC 2008c; 2009a).

Banks participating in the scheme had to adhere to a "code of ethics" for policies on executive compensation. Additionally, banks had to sign a Memorandum of Understanding (MoU) in which they committed to: a) increase lending for the next three years to small and medium-sized enterprises (SMEs); b) contribute to the guarantee fund for loans granted to SMEs; c) suspend up to 12 months of mortgage payments for borrowers that lost their jobs or benefited from public-income support; and d) ensure appropriate liquidity levels to creditors of public administrations. Banks were required to provide aggregated data on a quarterly basis to monitor the application of the MoU (Bank of Italy 2009b, 40–42; 2009c, 170–71). On July 31, 2009, Italy requested the EC to prolong its recapitalization scheme until December 31, 2009, which the EC approved (EC 2009c). The scheme was reintroduced ten months later on October 23, 2010, and ended December 31, 2010 (EC 2010b).

Outcomes

By the end of 2009, when the Italian recapitalization scheme first expired, capital injections totaled €4.05 billion. The four participating banks included: Banco Popolare for €1.45 billion, Banca Popolare di Milano for €500 million, Credito Valtellinese for €200 million, and Banca Montepaschi di Siena for €1.9 billion (see Table 2).

Table 2: Government Recapitalizations in Italy

Bank	Recapitalization (euros)	Date issued	Redeemed
Banco Popolare (BP)	1,450,000,000	Jul 31, 2009	Mar 14, 2011
Banca Popolare di Milano (BPM)	500,000,000	Dec 4, 2009	Jun 30, 2013
Credito Valtellinese (Creval)	200,000,000	Dec 30, 2009	Jun 13, 2013
Montepaschi di Siena (MPS)	1,900,000,000	Dec 30, 2009	
Total:	4,050,000,000		

Source: (EC 2010b, 2)

The announcement of the Tremonti bond decree in late February 2009 was accompanied with the speculation that the two largest Italian banks Unicredit and Intesa San Paolo would participate in government recapitalizations, each one for an amount of €3 billion (Reuters 2009a).

However, by May 2009, no recapitalization had taken place under the scheme. Tremonti expressed that banks had been too "relaxed" about using the recapitalization scheme. In May, four institutions reportedly requested around €6 billion from the Italian scheme: Unicredit, Banco Popolare, Banca Popolare di Milano and Banca Montepaschi di Siena. Unicredit's chief executive said that the bank planned to seek up to €4 billion in capital support from government programs in Austria and Italy (Mayer Brown 2009; Reuters 2009b).

Despite continuous speculation, Unicredit and Intesa San Paolo did not participate in the scheme and instead sought to raise capital through private investors. Seemingly to avoid government demands on lending. By the end of September 2009, UniCredit had a core Tier 1 ratio of 7.5% while Intesa Sanpaolo 7.2% (Reuters 2009c).

All four banks that the Italian government recapitalized agreed to a "code of ethics" for policies on executive compensation and signed an MoU committing to support SMEs and homeowners. Banco Popolare, the first bank recapitalized, announced in early March 2009, that it had formally requested the MEF and the Bank of Italy for approval to issue €1.45 billion in Tremonti bonds (BP 2009a; 2009b). The request was approved in mid-June 2009, and the bonds were issued at the end of July 2009. The bank committed to an increase of 6% on loans to SMEs over the next three years, and a €21.75 million contribution to the guarantee fund for loans granted to SMEs (BP 2009c; 2009d). In March 2011, Banco Popolare completed redemption of the Tremonti bonds, and paid €86.4 million on accrued interest payments between July 2010 and March 2011. The bank reported that Tremonti bonds contributed to an increase in lending to households by 9% in 2009 and 7.2% by September 2010. While for SMEs, the increase was 5% in 2009, and 7.1% by September 2010 (BP 2011).

Banca Popolare di Milano announced in late March 2009 its intention to issue €500 million in Tremonti bonds after reporting a 77% slide in annual profits (Mayer Brown 2009). In September 2009, the bank reached an agreement with the MEF and expected the injection to raise its core Tier 1 ratio from 6.2% to 7.6% (Financial Times 2009). The bonds were issued in early December 2009 and the bank completed the redemption of the Tremonti bonds in June 2013 (BPM 2009; 2013). Credito Valtellinese issued €200 million in Tremonti bonds on December 30, 2009. The bank committed to increase loans to SMEs by 4% (Creval 2009). In June 2013, the bank completed redemption of the Tremonti bonds (Creval 2013).

Banca Montepaschi di Schiena announced in March 2009 that it would issue €1.9 billion in Tremonti bonds. In August 2009, the Bank of Italy gave the bank the green light to negotiate the terms of the bond issuance with the MEF. By the end of June 2009, its tier 1 capital ratio stood at 5.8% but was expected to increase to 7.3% after the recapitalization (Italian News 2009). The MEF approved the issue of Tremonti bonds in mid-December 2009 and injected the capital on December 30, 2009. The MoU included an estimated 4.5% increase in loans to SMEs. This was an additional €10 billion a year for SMEs for the next two years, on top of the €70.2 billion disbursed on average in the past two years. Additionally, the bank committed to contribute €28.5 million guarantee fund for loans to SMEs (MPS 2009).

In late May 2009, Moody's downgraded the Italian banking sector from stable to negative. While it expected a deterioration in asset quality and profits, it said that Italian banks were unlikely to require "strong government backing," due to less exposure to toxic assets, investment activities and capital market funding. A week later, Standard & Poor's also forecasted an increase in loan losses and non-performing assets in Italian banks through 2010 (Mayer Brown 2009).

As seen in Table 3, by September 2009, the core Tier 1 capital ratio of the largest Italian banks reached 7.3% and by March 2010, 7.6% (Draghi 2010a; 2010b, 12). It was generally lower than other major European banks. However, Bank of Italy's governor Mario Draghi explained that the differences laid in the substantial public recapitalizations abroad and the more stringent criteria used in Italy to classify regulatory capital. Governor Draghi emphasized that the largest Italian banks held high-quality capital and were less leveraged compared to other major European banks. Nonetheless, Draghi through 2009 and 2010 continued to stress the importance on strengthening capital ratios. In a speech in July 2009, he expressed:

> "I have said, and I say again, that a strengthening is nonetheless necessary. It is not just a question of maintaining strong safeguards for stability; we must compete on an equal

footing with the foreign banks which have had to resort to massive injections of public money in recent months; we must be prepared, as of now, to operate with a capital endowment that future regulations will require to be larger than at present. Above all, capital strengthening is indispensable in order to face the deterioration in the macroeconomic situation without neglecting to give firms, households and the economy the support they need" (Draghi 2009).

Table 3: Italian Banks - Capital Ratios in 2008 and 2009

Capital adequacy of Italian banks and banking groups (1)
(end-of-period data in millions of euros)

	Banking system		Main groups (2)	
	2009	2010	2009	2010
Allocations to regulatory capital	5,988	5,171	3,584	3,195
Regulatory capital	218,621	227,957	131,662	136,291
Core tier 1 capital ratio (%)	8.2	8.3	7.2	7.4
Tier 1 capital ratio (%)	8.9	9.3	8.3	9.0
Total capital ratio (%)	12.0	12.4	11.8	12.6
Financial leverage (3) (4)	19	19	22	22
Excess capital	72,699	81,558	42,595	49,454

Sources: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to a group. (1) Excludes the Italian branches of foreign banks. – (2) Five largest groups by total assets as of December 2010. – (3) Ratio of total balance sheet assets to tier 1 capital. – (4) Provisional data.

Source: (Bank of Italy 2011, 145)

II. Key Design Decisions

1. The Italian recapitalization scheme was part of a package in response to the global financial crisis (2007-2009).

On October 9, 2008, Italy issued Decree Law N. 155, "Urgent measures to guarantee the stability of the credit system and the continued flow of credit to firms and consumers in the current state of crisis in world financial markets." The decree envisaged a government support package focused on three areas: i) recapitalizations, ii) access to liquidity, and iii) expanded guarantees on bank deposits (Bank of Italy 2008, 21). The €80 billion Italian economic stimulus plan announced on November 15, 2008, was considered low at an estimated 0.6% of GDP (Financial Times 2008; Bank of Italy 2009d, 5).

2. The Italian Decree-Law N. 185/2008, later converted into Law N. 2/2009 was the legal basis for the Italian recapitalization scheme.

The legal basis for the Italian recapitalization scheme for sound banks was Article 12 of Decree-Law 185 of November 29, 2009, later converted into Law N. 2/2009 on January 28, 2009 (Bank of Italy 2009c, 170–71).

3. The European Commission approved the Italian recapitalization scheme under EU State aid rules compatible with the EC Treaty.

On December 18, 2008, Italy notified the European Commission (EC) of its recapitalization scheme. The EC approved it on December 23, 2008, after intensive exchanges with Italian officials. The scheme was in line with EU State aid rules, as a temporary measure and compatible with Article 87 (3)(b) "intended to stabilize the markets as a response to the global financial crisis" (EC 2008b; 2008c)

The government expected the scheme to have its first operations by January 2009. However, with no use of the scheme, on February 16, 2009, Italy notified the EC of an amendment, which as approved on February 22, 2009. The amendment became operational on February 25, 2009, with an Italian Ministerial decree. On July 31, 2009, Italy requested the EC to prolong its recapitalization scheme, until December 31, 2009, which was approved in October 2009 (EC 2009c). After its expiration, the scheme was later reintroduced ten months later on October 23, 2010, until December 31, 2010 (EC 2010b).

4. Italy and other countries communicated government interventions to contain the financial crisis.

In October 2008, in a period of ten days, multiple high-level government meetings took place intended to coordinate an international response and establish common measures to combat the crisis. The meetings included the EU Economic and Financial Affairs Council (ECOFIN) on October 7, 2008; the G7 summit in Washington D.C. on October 10; an emergency Euro summit of heads of state on October 12; and the European Council meeting on October 15-16.

The Euro heads of state released the "Declaration on a concerted European action plan of the Euro area countries" which committed efforts to reestablish confidence and promote the sound functioning of the financial system. In agreement with the EC and the European Central Bank (ECB), the plan outlined support to financial institutions by facilitating: a) appropriate liquidity conditions, b) funding of banks, c) additional capital resources, d) recapitalizations of distressed banks, e) flexibility in the implementation of accounting rules, and f) cooperation among European countries (Euro Summit 2008). A few days later, the European Council endorsed the plan of action and extended it to all countries part of the European Union (Euro Council 2008).

As seen in Table 3, by September 2009, the core Tier 1 capital ratio of the largest Italian banks reached 7.3% and by March 2010, 7.6% (Draghi 2010a; 2010b, 12). It was generally lower than other major European banks. However, Bank of Italy's governor Mario Draghi explained that the differences laid in the substantial public recapitalizations abroad and the more stringent criteria used in Italy to classify regulatory capital. Governor Draghi emphasized that the largest Italian banks held high-quality capital and were less leveraged compared to other major European banks. Nonetheless, Draghi through 2009 and 2010 continued to stress the importance on strengthening capital rations. In a speech in July 2009, he expressed:

> "I have said, and I say again, that a strengthening is nonetheless necessary. It is not just a question of maintaining strong safeguards for stability; we must compete on an equal footing with the foreign banks which have had to resort to massive injections of public money in recent months; we must be prepared, as of now, to operate with a capital endowment that future regulations will require to be larger than at present. Above all, capital strengthening is indispensable in order to face the deterioration in the macroeconomic situation without neglecting to give firms, households and the economy the support they need" (Draghi 2009).

5. The Italian Ministry of Economy and Finance managed the recapitalization scheme with support from the Bank of Italy.

The Ministry of Economy and Finance (MEF) was empowered to inject capital in eligible institutions until December 31, 2009. The Bank of Italy assessed the bank's solvency, capital adequacy, and risk profile.

6. Initially, the size of the recapitalization scheme was between €15 and €20 billion. In February 2009, with the introduction of the Tremonti bonds the size was reported to be up to €12 billion.

The total available funds for the Italian recapitalization scheme was unspecified but expected to be between €15 and €20 billion (EC 2008b). Italian authorities made clear that support would be available "as needed" (Bank of Italy 2009d, 25). In February 2009, when the scheme was amended, the size of the scheme was reported to be up to €12 billion (Reuters 2009a).

7. Eligible institutions included fundamentally sound Italian banks (including subsidiaries of foreign banks) with shares listed in the regulatory market.

Eligible institutions included fundamentally sound Italian banks (including subsidiaries of foreign banks) with shares listed in the regulatory market. The Bank of Italy determined if a bank was fundamentally sound by considering available risk indicators. These included: spreads on credit default swaps on subordinated debt (median value must had not exceeded 100 basis points in the period from January 2007 to August 2008) and credit ratings of at least A- (Bank of Italy 2009b, 40–41; EC 2008c, 2)

In late 2009, when the scheme was prolonged, Italy made additional commitments:

(a) to inform the EC, at the moment of the recapitalization, of the bank's risk profile to enable the EC to evaluate its viability and assess if could be considered fundamentally sound or required restructuring. The material would include a review from the Bank of Italy on the soundness and viability of the bank. The EC would be provided with any additional information for its assessment of the bank's viability. Italy committed to submit within six months the relevant information of each bank recapitalized to enable the EC to review the bank's risk profile and viability so that it could assess if it could still be considered fundamentally sound.

(b) when a bank applied for a second recapitalization, Italy would submit an individual notification. The EC would assess if the bank could still be considered fundamentally sound or if it required restructuring (EC 2009c).

8. Recapitalizations consisted of "Tremonti bonds," which were perpetual and convertible into common shares after three years.

The Italian government, through the MEF, acquired "special bonds" known as "Tremonti bonds" to support banks' balance sheets. For some commentators, the fact that banks paid interest on the bonds gave the scheme a more market-orientated feel compared to other European schemes were banks had been nationalized (Markit 2009). The Tremonti bonds were designed to have the same characteristics as common shares in order to qualify as core Tier 1 capital. They had the same degree of subordination and same ability to absorb losses, both in case of insolvency or when losses reduced total capital ratios below the regulatory minimum of 8%.

Tremonti Bonds were perpetual and convertible into common shares after three years. Interest was non-cumulative and only paid if there were distributable earnings, provided the total capital ratio was at least 8%. Public bank recapitalizations were limited to 2% of a bank's risk-weighted assets, and without surpassing 8% of Tier 1 capital ratio (Bank of Italy 2009b, 40–42).

Banks could redeem the Tremonti bonds given authorization by the Bank of Italy, by paying a premium on the face value, which could increase over time in relation to the market value of the bank's shares. The conversion ratio of Tremonti bonds into shares was fixed based on the average share price of the last ten trading days before the issue (Bank of Italy 2009b, 40–42).

9. Remuneration and redemption conditions on Tremonti bonds were revised to encourage participation in the recapitalization scheme.

The remuneration conditions were designed in line with EU State aid rules to be temporary, to encourage an early exit. The EC recommended an indicative range based on the type of instrument. For subordinated debt, such as preferred shares, the EC recommended an average required rate of return of 7%. While for common shares, the EC recommended an average required rate of return of 9.3% (EC 2008a, 8).

The conditions aimed to ensure an adequate remuneration for the government and protect the interests of taxpayers. Additionally, to minimize distortive effects of recapitalizations, remuneration included an initial coupon with fixed step-up clauses, increases in remuneration associated with dividend payments and the government's financing costs, and a redemption price premium that increased over the years. To encourage early redemption by banks once the crisis was over, the redemption price was set higher than the nominal value and increased over time (see Table 4)(Bank of Italy 2009b, 40–42; EC 2008b; 2008c).

When the recapitalization scheme was introduced in December 2008, the Italian government set the annual rate of return on the bonds at 7.5% for the first six months. Thereafter, it was the highest of these three options:

a) A predetermined annual coupon, increasing over time: 7.5% in 2009, 7.75% in 2010, 8% in 2011, 8.25% in 2012, and 8.5% in 2013 and 2014. Then, it would rise in increments of 0.5% every two years (9% in 2015 and 2016, 9.5% in 2017 and 2018, etc.), up to 15% in 2039;

b) An amount equal to the product of the dividend per share distributed to common shareholders and the number of shares. This amount was increased by an increasing percentage over time. 105% of dividends, in whatever capacity and in any form paid, in relation to 2009 profits, 110% for 2010, 115% for 2011-2017, and 125% for 2018 and following years, or

c) The average yield on 30-year Italian Treasury bonds (BTP) increased by a spread. Starting in 2011, the yield at the issuance of the 30-year BTP, increased by 300 basis points, then starting in 2013, the 30-year BTP yield increased by 350 basis points (EC 2008c, 3–4).

For the second option introduced in February 2009, the interest rate was higher starting at 8.5%. Thereafter, the interest rate would be the highest of the following three elements:

a) A predetermined annual coupon, increasing over time: 8.5% in 2009, 2010, 2011 and 2012, 9% in 2013, 2014, 2015 and 2016, and then in increments of 0.5% every two years (9.5% for 2017 and 2018 and so forward, followed up to 15% for 2039) or

b) An amount equal to the product of the dividend per share distributed to common shareholders and the number of shares. This amount was increased by an increasing percentage over time. 105% of the dividend, in any capacity and in any form paid, in 2009 profits, 110% in 2010, 115% for 2011-2017, and 125% for 2018 and following years, with a maximum limit of 15% of the nominal value, or

c) The average yield on 30-year BTP increased by a spread. Starting in 2011, the issuing yield of the 30-year BTP increased by 300 basis points, then, starting in 2013 and for the following years, the 30-year BTP yield plus 350 basis points (EC 2009b, 4–5).

Additionally, provisions were placed where the government could accept a lesser remuneration. But only in cases where at least 30% of the bank's issuance was subscribed by private investors (at least two thirds other than shareholders owning 2% or more of the share capital) on equal terms with the Italian government. In any case, the yield had to be at least 200 basis points above the average yield of 30-year BTP (Bank of Italy 2009b, 41; EC 2009a)

For the first option, the redemption price would be the highest between 110% of the nominal value at issuance and the market value of the bank shares in circulation. The redemption price was set within a percentage value of the nominal value equal to 120% in the event of redemption by June 30, 2013; 130% between July 1, 2013 and June 30, 2016; 140% between

July 1, 2016 and June 30, 2019; 150% between July 1, 2019 and June 30, 2022; and 160%, in case of redemption from July 1, 2022 onwards (EC 2008c, 5).

For the second option, the redemption price was set within a percentage value of the nominal value equal to 100%, in the event of redemption by June 30, 2013, and 110%, in the event of redemption between the July 1, 2013 and June 30, 2015. For the following years, the redemption price was set as the highest of: 110% of the nominal value of the Tremonti bonds at issuance and the market value of the bank shares in circulation, with a maximum limited to a percentage of the nominal value equal to 130% in the event of redemption between July 1, 2015 and June 30, 2016; 140% between July 1, 2016 and June 30, 2019; 150% between July 1, 2019 and June 30, 2022; and 160% from July 1, 2022 onwards (EC 2009b, 5).

EC Competition Commissioner Neelie Kroes mentioned that "The Italian authorities have asked permission to modify the design of their scheme to make it more attractive to sound banks that are willing to use the state capital only for a very short period of time" (EC 2009a). The first option of remuneration consisted of lower coupon payments and higher redemption prices up to 2014. While the second option consisted of an alternative remuneration option with a higher initial coupon and a higher annual level of the coupon until 2014. Starting in 2015, the two schemes have identical characteristics (see Table 4).

Table 4: Tremonti bonds – The two options of remuneration

Table

Characteristics of the recapitalization instruments

Financial year (1)	Interest: the highest of				Redemption price (% of face value) (5)			
	Annual coupon (% of face value) (2)		Dividends (2) (3)	State's borrowing cost (4)	Minimum		Maximum	
	Option 1	Option 2			Option 1	Option 2	Option 1	Option 2
2009	7.50	8.50	1.05 * DIV		110	100	120	100
2010	7.75	8.50	1.10 * DIV		110	100	120	100
2011	8.00	8.50	1.15 * DIV	BTP30 + 300bps	110	100	120	100
2012	8.25	8.50	1.15 * DIV	BTP30 + 300bps	110	100	120	100
2013	8.50	9.00	1.15 * DIV	BTP30 + 350bps	110	110	130	110
2014	8.50	9.00	1.15 * DIV	BTP30 + 350bps	110	110	130	110
2015	9.00		1.15 * DIV	BTP30 + 350bps	110		130	
2016	9.00		1.15 * DIV	BTP30 + 350bps	110		140	
2017	9.50		1.15 * DIV	BTP30 + 350bps	110		140	
2018	9.50		1.25 * DIV	BTP30 + 350bps	110		140	
2019	10.00		1.25 * DIV	BTP30 + 350bps	110		150	
2020	10.00		1.25 * DIV	BTP30 + 350bps	110		150	
2021	10.50		1.25 * DIV	BTP30 + 350bps	110		150	
2022	10.50		1.25 * DIV	BTP30 + 350bps	110		160	
2023	11.00		1.25 * DIV	BTP30 + 350bps	110		160	
ecc.								

(1) For purposes of the (deferred) payment of interest and determination of the redemption price, the financial year runs from 1 July of the year shown in the table to 30 June of the following year. – (2) Interest calculated on the basis of the annual coupon or the amount of dividends cannot be greater than 15 per cent of the issue's face value. – (3) For each financial year, DIV corresponds to the product of the dividend per share distributed to ordinary shareholders (on any basis and in any form) and the number of shares underlying the issue. – (4) BTP30 is the average of the yields at issue of thirty-year Treasury bonds recorded in the first quarter of the year in which interest is paid; pbs = basis points. – (5) The redemption price is equal to the average market value of the shares underlying the issue in the thirty days preceding the redemption date if that value is between the minimum and maximum shown in the table. If the market value is below the minimum, the redemption price is the minimum; if the market value is above the maximum, the redemption price is the maximum.

Source: (Bank of Italy 2009b, 42)

10. Banks recapitalized had to sign a Memorandum of Understanding committing to a code of ethics and lending to SMEs and households.

Banks participating in the government recapitalizations had to adhere to a "code of ethics" for policies on executive compensation. Additionally, banks had to sign a Memorandum of Understanding (MoU), that committed to: a) increase lending for the next three years to small and medium-sized enterprises (SMEs); b) contribute to the guarantee fund for loans granted to SMEs; c) suspend up to 12 months of mortgage payments for borrowers that lost their jobs or benefiting from public-income support; and d) ensure appropriate liquidity levels to creditors of public administrations.

The commitments of the MoU remained valid until the bank redeemed the Tremonti bonds to the government. Banks were required to provide aggregated data on a quarterly basis to monitor compliance. The Bank of Italy would assess the bank's compliance with capital requirements (i.e. Tier 1) and its profitability. In line with the EU State aid guidelines, limits were set on the expansion of a bank's assets, and additional conditions to prevent banks from misusing public support (Bank of Italy 2009a, 30–31; 2009b, 40–42).

III. Evaluation

In 2010, Italian authorities expressed that the Italian recapitalization scheme "exhibited satisfactory performance in its implementation, providing a safety net that corresponds well to market needs and ensuring the provision of lending to the real economy" (EC 2010b, 2).

The core Tier 1 capital ratio of the largest Italian banks stood at 5.8% by the end of 2008 and increased in the first three months of 2009 (Draghi 2009; 2010a). Premiums on credit default swaps had risen, but announcements by major Italian banks of their intention to use the recapitalization scheme and increases in profits contributed to reduce the premiums by more than half (Bank of Italy 2009c, 139, 212).

In February 2010, Italy's central bank governor Mario Draghi expressed that Italian banks were "well placed to cope with the international environment." Draghi noted that their capital bases were strengthened by the issue of shares, disposal of non-core assets, the ploughing back of profits and, in some cases, government interventions (Draghi 2010a).

The scheme expired on December 31, 2009, however, it was reintroduced ten months later on October 23, 2010, until December 31, 2010. The Italian government cited protracted effects of the global financial crisis and recent results of stress tests performed by the Committee of European Banking Supervisors (EC 2010a; 2010b).

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VI. Appendices

Appendix A: Timeline

Date	Event	Description
Oct/07/2008	The European Council of Economic and Financial Affairs (ECOFIN) met to plan a response to the global financial crisis.	The ECOFIN approved a set of principles and extraordinary measures for European governments to combat the crisis (ECOFIN 2008)
Oct/09/2008	Italy issued Decree-Law N. 155	Decree Law N. 155, "Urgent measures to guarantee the stability of the credit system and the continued flow of credit to firms and consumers in the current state of crisis in world financial markets." The decree envisaged a government package focused on three areas of support to the Italian banking sector: a) bank recapitalizations, b) access to liquidity, and c) expanded guarantees on bank deposits (Bank of Italy 2008, 21).
Oct/10/2008	G7 summit in Washington D.C, USA.	The G7 finance ministers and central bank governors pledged to take aggressive actions that included: support for systemically important financial institutions, all necessary efforts to ensure credit access to banks, temporary guarantees on short and medium-term liabilities, expansion of guarantees on bank deposits, bank recapitalization through the use of public funds, and acquisition of illiquid assets (G7 2008).
Oct/12/2008	Euro summit of heads of state in Paris, France.	The Euro heads of state released the "Declaration on a concerted European action plan of the Euro area countries" which committed efforts to reestablish confidence and the well-functioning of the financial system. In agreement with the European Commission (EC) and the European Central Bank (ECB), the plan outlined support to financial institutions by facilitating: a) appropriate liquidity conditions, b) funding of banks, c) additional capital resources, d) recapitalizations of distressed banks, e) flexibility in the implementation of accounting rules, and f) cooperation among European countries (Euro Summit 2008).
Oct/13/2008	The European Commission releases the "Banking Communication."	The European Commission provided guidance on the application of State aid measures for banks in the context of the global financial crisis. It highlighted that recapitalization schemes were important measures Member States could take to preserve

		financial stability and proper functioning of financial markets. Link 1, Link 2
Oct/15/2008	European Council meeting.	The European Council endorsed the plan of action and extended it to all countries part of the European Union (Euro Council 2008).
Nov/20/2008	ECB released a recommendation on the pricing of bank recapitalizations.	(ECB 2008)
Dec/02/2008	The ECOFIN Council anticipates the need for further recapitalizations.	The ECOFIN council expresses that it "recognized the need for further guidance for precautionary recapitalizations to sustain credit, and called for its urgent adoption by the European Commission. Link
Dec/05/2008	The European Commission releases a communication for recapitalization schemes.	The Communication "The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition" provided guidance for new recapitalization schemes and adjustments of existing ones (EC 2008).
Dec/23/2008	EC approval of EU State aid case N. 648/2008	Recapitalization measures in favor of the Italian banking sector (EC 2008c).
Feb/22/2009	EC approved amendment. EU State aid case N. 97/2009	The European Commission approved amendments to the Italian recapitalization scheme to offer a second offer of remuneration, more attractive for banks that plan to use the government capital for a short period of time (EC 2009b).
Oct/06/2009	EC approved a prolongation of the scheme until December 31, 2009. State aid case N. 466/2009	
Aug/05/2010	Italian Decree-Law N. 125, Art 2.1. Published in the Italian Official Journal n. 182	The passage became the legal basis for the Italian recapitalization scheme.
Oct/21/2010	EC approved the re-introduction of the Italian recapitalization scheme. State Aid case N. 425/2010	The scheme expired on December 31, 2009. Italy requested the EC to re-introduce the scheme until December 31, 2010.