Client Alert | Banking / Capital Markets

Italy implements the Bank Recovery and Resolution Directive

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On January 1, 2016, two Italian legislative decrees that implement the Bank Recovery and Resolution Directive No. 2014/59/EU ("BRRD") in Italy came into force in full.

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Executive Summary

*The Bank Recovery and Resolution Directive No. 2014/59/EU ("**BRRD**") establishes a common framework for the recovery and resolution of banks and large investment firms in all EU Member States.*

Pursuant to the BRRD, shareholders and creditors of failing institutions will pay their share of costs through a "bail-in" mechanism, whereby the value of shares, bonds, uninsured deposits or other liabilities of any such institution may be written down or liabilities may be converted into equity. The bail-in is subject to the order of priority specified in the implementing legislation, which may to some extent differ across Member States.

The main focus of discussion in Italy has been on the relative treatment of two classes of creditors: depositors and senior bondholders. Traditionally bonds issued by Italian banks have been made available to, and acquired in large numbers by, retail investors. In effect bonds have been perceived as savings products as much as investment products.

*However, the new decrees give bank deposits – above or below the EUR 100,000 threshold for the coverage of the deposit guarantee scheme, and held by large enterprises and other banks as well as by private individuals or micro, small and medium-sized enterprises ("**SMEs**") – priority over bonds (including retail bonds) in the case of resolution or liquidation. Based on the discussions which took place during the consultation, the application of the "extended" depositor preference for large enterprises – which is not provided for under the BRRD and represents an Italian peculiarity – has been delayed and the relevant rules will apply from January 1, 2019 onwards.*

Background: the BRRD and SRM within the context of the EU Banking Union

The BRRD was adopted in response to the public bail-outs of banks during the financial crisis. The main objectives of the BRRD are to ensure the stability of institutions providing banking and financial services in the single market through the harmonization and improvement of the tools for dealing with bank crises across the EU and to reduce the likelihood that a taxpayer bail-out is required.

The BRRD is one of the legislative texts constituting the "Single Rulebook", which represents the legal foundation of the EU Banking Union. In particular, the BRRD lays down the substantial provisions to be applied within the context of the Single Resolution Mechanism ("**SRM**"), which is one of the three pillars of the EU Banking Union, together with the Single Supervisory Mechanism ("**SSM**") and the European Deposit Insurance Scheme ("**EDIS**")[1].

In order to ensure consistency with the SSM framework – which governs the relations between the European Central Bank ("**ECB**") and national competent authorities for the supervision of banks established in the Eurozone – the SRM introduces an integrated decision-making structure for resolution matters through the establishment of the Single Resolution Board ("**SRB**"). As from January 1, 2016, the SRB is directly responsible for resolution of entities directly supervised by the ECB and cross-border groups, while national resolution authorities are responsible for all other entities (save for certain exceptions).

The implementation of the BRRD in Italy

The BRRD originally required EU Member States to adopt and publish implementation measures by December 31, 2014 and to apply those measures (except for bail-in) from January 1, 2015. However, the Italian Government (along with other EU countries) failed to do so by the required deadline.

On July 2, 2015, a law was passed by the Italian parliament delegating to the Italian Government the powers necessary to implement the BRRD through the enactment of legislative decrees (*decreti legislativi*). Following a public consultation conducted by the Ministry of Economy and Finance, such legislative decrees were finally approved on November 16, 2015.

Legislative Decree No. 180 of November 16, 2015 ("**Legislative Decree 180**") is a stand-alone law and contains the core of the BRRD framework. It deals with the preparation of resolution plans, opening and closing of resolution procedures, adoption of resolution tools, crisis management of cross-border groups, powers and functions of the competent resolution authority (i.e. the Bank of Italy[2]) and rules on the establishment and functioning of the national resolution fund.

The regulatory framework set out under Legislative Decree 180 is supplemented by Legislative Decree No. 181 of November 16, 2015 ("**Legislative Decree 181**"), which amends both Legislative Decree No. 385 of September 1, 1993 (the Italian Banking Law or "**TUB**") and Legislative Decree No. 58 of February 24, 1998 (the Italian Financial Law or "**TUF**") introducing a number of provisions concerning recovery plans, intra-group financial support and early intervention measures. Legislative Decree 181 also amends the provisions governing the extraordinary administration (*amministrazione straordinaria*) and compulsory administrative liquidation (*liquidazione coatta amministrativa*) in order, *inter alia*, to align such rules with the new regime established by the BRRD and introduce certain significant changes to the provisions on creditors' hierarchy in the case of resolution or liquidation – as better detailed below.

On December 16, 2015, Legislative Decree 180 and Legislative Decree 181 were published in the Italian Official Gazette. Most of the provisions entered into force on the same date – except, *inter alia*, for the rules on bail-in (which became effective from January 1, 2016).

[1] The proposal for a regulation establishing the EDIS was published by the European Commission on November 24, 2015 and is currently under discussion. National deposit guarantee schemes are already regulated under the Deposit Guarantee Schemes Directive No. 2014/49/EU, recasting Directive No. 94/19/EC.

[2] Consistently with the provisions of Legislative Decree 180, reference will be made in the following paragraphs to the Bank of Italy as competent resolution authority. However, these provisions must be read in conjunction with those relating to the allocation of powers and tasks between the SRB and national authorities under the SRM Regulation (EU) No. 806/2014 and the additional rules set forth therein.

Crisis prevention measures and resolution tools

Entities that are subject to the BRRD provisions[3] are now required to comply with a number of new requirements, in particular with respect to the drafting of individual or group recovery plans, which must be periodically submitted to competent authorities for review[4]. Alongside this process, the Bank of Italy must draw up individual or group resolution plans and periodically assess the resolvability of any such institution or group, with the power to address or remove any related impediments. Where certain conditions are met, competent authorities may also adopt early intervention measures – including the removal of senior management and the management body and the appointment of a temporary administrator – with a view to preventing the occurrence of possible bank failures.

In addition to the preventive measures mentioned above, Legislative Decree 180 entrusts the Bank of Italy with the power to adopt the following resolution tools.

Resolution tools

Sale of business	Sale to a third party purchaser of the shares or part or all of the assets, rights or liabilities of the institution under resolution.
Bridge institution	Transfer of the shares or part or all of the assets, rights or liabilities of the institution under resolution to a temporary "bridge" entity wholly or partially owned by the resolution fund (or other public authorities) and created with a view to maintaining access to critical functions and selling the transferred shares, assets, rights and liabilities.
Asset separation	Transfer of assets, rights or liabilities of the institution under resolution to an asset management vehicle (also known as a "bad bank").
Bail-in	Write-down and/or conversion of the liabilities of the institution under resolution.

These resolution tools may be applied individually or in any combination. However, the asset separation tool may only be applied together with another resolution tool.

Conditions for resolution and related principles

The Bank of Italy is entitled to adopt the resolution tools and take the other resolution actions contemplated under Legislative Decree 180 if: (i) the bank or investment firm is failing or is likely to fail; (ii) it is not possible to avoid such failure with a private sector intervention or a supervisory action by the Bank of Italy; and (iii) the resolution action is necessary in the public interest.

Any resolution action to be taken by the Bank of Italy will be governed, *inter alia*, by the following principles:

1. shareholders and creditors will bear the losses in accordance with the applicable order of priority and will be treated in the same manner if they belong to the same class ("*pari passu*" principle) unless otherwise provided under Legislative Decree 180;
2. no shareholder or creditor will incur greater losses than it would have incurred if the institution had been subject to compulsory administrative liquidation or a similar procedure ("no creditor worse off" principle);

[3] The Italian BRRD framework applies to (i) Italian banks, (ii) Italian holding companies of banking groups, (iii) companies included in a banking group or subject to consolidated supervision pursuant to article 15, para. 1, letters c) and h) of the TUB and (iv) companies established in Italy and subject to consolidated supervision in other EU Member States. The same provisions apply to Italian investment firms (*SIM*) performing certain services (i.e. dealing on own account, underwriting / placement of financial instruments and/or management of multilateral trading systems) and related investment firms' groups (*gruppi di SIM*) as defined under article 11 of the TUF. The Bank of Italy operates as resolution authority also with respect to Italian branches of non-EU banks or investment firms.

[4] Depending on the allocation of tasks under the SSM, the competent authority may be the ECB or the Bank of Italy.

3. covered deposits (not exceeding EUR 100,000) are fully protected and therefore no loss will be borne by covered depositors;
4. corporate bodies and senior management of the institution will be replaced, except where their retention is necessary for the achievement of the resolution objectives.

The bail-in mechanism

Through the bail-in tool the Bank of Italy may provide for either the reduction of the value or the conversion into equity of the liabilities of the failing institution. Since the application of such resolution tool results in losses being borne by creditors or their claims being converted into equity, the Bank of Italy will exercise the power to write down and/or convert capital instruments immediately before or together with the application of the bail-in tool.

Accordingly, in the case of resolution, losses should first be absorbed by shares and other regulatory capital instruments and allocated to their holders, in accordance with the following order of priority, reflecting the regulatory capital structure provided under the "CRR" Regulation (EU) No. 575/2013: (i) Common Equity Tier 1 Capital; (ii) Additional Tier 1 Capital; and (iii) Tier 2 Capital[5]. If this is not sufficient, losses should be absorbed by debt instruments and other creditors, in accordance with the order of priority and subject to the exemptions summarized in the tables below.

Order of seniority in the case of bail-in (items in white bailed-in first, starting from Common Equity Tier 1 Capital)

Prior to January 1, 2019	From January 1, 2019 onwards
Deposits of natural persons and SMEs above EU 100,000	Deposits of natural persons and SMEs above EUR 100,000
Deposits of large enterprises exceeding EUR 100,000 and senior bonds / liabilities (*pari passu*)	Deposits of large enterprises exceeding EUR 100,000
	Senior bonds / liabilities
Subordinated bonds / liabilities	Subordinated bonds / liabilities
Tier 2 Capital	Tier 2 Capital
Additional Tier 1 Capital	Additional Tier 1 Capital
Common Equity Tier 1 Capital	Common Equity Tier 1 Capital

5 The terms and conditions of Additional Tier 1 and Tier 2 instruments issued, or which may be issued in the future, by Italian banks already provide for the write down of the relevant instrument's principal amount under certain circumstances. However, the powers described above are additional to the contractual terms of such securities.

Liabilities excluded from bail-in

1.	Deposits covered by the deposit guarantee scheme (i.e. up to EUR 100,000).
2.	Secured liabilities (including, inter alia, covered bonds).
3.	Liabilities arising from the holding of client money or client assets[6].
4.	Liabilities arising by virtue of a fiduciary - beneficiary relationship[6].
5.	Liabilities to banks or investment firms (not belonging to the institution's group) with an original maturity of less than seven days.
6.	Liabilities to settlement systems or central counterparts with a remaining maturity of less than seven days.
7.	Liabilities to employees[7], trade creditors, tax and social security authorities or deposit guarantee schemes.

The preference granted to uninsured deposits held by large enterprises over other unsecured indebtedness is a peculiarity of the BRRD implementation in Italy as compared to other EU Member States' liquidation and resolution waterfalls. This "extended" depositor preference will however apply only from January 1, 2019.

Minimum Requirement for Own Funds and Eligible Liabilities (MREL)

Another key element of the BRRD framework is represented by the minimum requirement for own funds and eligible liabilities ("**MREL**"), which is aimed at ensuring that banks and investment firms have sufficient liabilities which are eligible for bail-in. The amount of MREL that institutions should have will be determined by the Bank of Italy on the basis of the criteria set out in Legislative Decree 180 and related implementing regulations as well as in the EBA regulatory technical standards to be endorsed by the European Commission. The determination of such amount and assessment of compliance with the MREL by the relevant institution will be made by the resolution authority in parallel with the development and the maintenance of resolution plans.

What next?

The BRRD provisions will have a significant impact on banks and investment firms not only in the event of a crisis or financial distress but also in the performance of their ordinary business.

Recovery plans will require substantial organizational effort in terms of timing and resources. The impact of the MREL requirement will also need to be assessed and monitored, as compliance therewith may require institutions to, *inter alia*, adjust their capital structure and/or issue new bail-inable instruments[8].

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[6] Provided that the claimant is protected under applicable insolvency law.

[7] The exclusion from the bail-in tool applies to the fixed components of the remuneration (i.e. accrued salary, pension benefits and other fixed remuneration) as well as to the variable component of the remuneration regulated by collective bargaining agreements. The variable remuneration of the "identified staff" (as defined under the CRD IV rules on remuneration) is subject to bail-in.

[8] In addition to the MREL, global systemically important banks (G-SIBs), of which UniCredit is currently the only Italian example, will also have to take into account the possible introduction of the total loss-absorbing capacity ("TLAC") standard proposed by the Financial Stability Board – which, according to the current proposal, will not apply before January 2019.

A crucial aspect in Italy relates to the arrangements adopted by Italian banks for the distribution of financial instruments subject to bail-in to their clients. This issue has already been addressed by Consob in a recent communication providing guidelines on the MiFID rules of conduct applying in these circumstances[9].

Finally, another issue that may arise relates to the possibility for resolution authorities to discriminate among creditors belonging to the same class (e.g. senior bondholders) – for instance in order to protect the interests of retail bondholders (as opposed to bondholders qualifying as professional investors) – considering that under the BRRD framework derogations from the *pari passu* principle seem to be permitted only in exceptional cases[10].

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[9] See Consob Communication No. 0090430 of November 24, 2015, which shall be read in conjunction with the previous communications on illiquid and complex products (No. 9019104 of March 2, 2009 and No. 0097996/14 of December 22, 2014 respectively).

[10] In particular, Legislative Decree 180 provides that the Bank of Italy may exclude, in whole or in part, certain liabilities from the application of the bail-in where at least one of the following conditions is met: (i) it is not possible to bail-in those liabilities within a reasonable time; (ii) the exclusion is strictly necessary and proportionate to achieve the continuity of critical functions and core business lines of the institution under resolution or to avoid giving rise to contagion; (iii) the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in.