Client Alert | Banking / Capital Markets

The Italian State Steps In: Government Guarantees and Precautionary Recapitalizations of Italian Banks

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The Italian government has taken important steps to stabilize troubled Italian banks by approving Law Decree No. 237/2016 (the "**Law Decree**")[1].

The Law Decree authorizes the Italian government to support Italian banks through:

- the issue of a State guarantee over new liabilities in the form of debt securities and emergency liquidity assistance ("**ELA**") facilities;
- precautionary recapitalization measures, which require burden sharing by private investors in line with EU State aid rules.

A €20 billion fund has been budgeted by the Italian government to finance these measures. State guarantees of recent debt issuances (by Banca Monte dei Paschi di Siena ("**MPS**"), Banca Popolare di Vicenza and Veneto Banca) have already been granted, while precautionary recapitalizations are expected to follow shortly.

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Background

Privately-sponsored or market-driven solutions – such as the Atlante fund and the attempted private sector rescue of MPS in 2016 – have failed to untangle the knots of the Italian banking system.

After the rejection of the referendum to overhaul the Italian Constitution in December 2016 and subsequent resignation of Prime Minister Renzi, the Italian government took action to address the Italian banking issues.

[1] The Law Decree was enacted by the Italian government on December 23, 2016 and converted into Law No. 15/2017 by parliament on February 17, 2017.

The Law Decree empowers the Italian government to (i) issue guarantees over newly issued debt securities and ELA facilities with the Bank of Italy and (ii) directly intervene in the capital of banks through precautionary recapitalizations.

Using public funds is not a simple path to take given EU rules on State aid and bank recovery and resolution[2] (see our alert "Italian banks: Thoughts on recapitalisation and sharing the burden"). State guarantees and precautionary recapitalizations may be considered extraordinary public financial support ("**EPFS**") under the BRRD. Approval of such measures may be granted by European governments only to remedy serious disturbances in the national economy and preserve financial stability[3]. Accordingly, EPFS measures must receive prior approval of the European Commission ("**EC**") in accordance with EU State aid rules. In this respect, investors holding hybrid capital instruments and subordinated debt are required to share the burden of precautionary recapitalizations as a condition for any capital injection by an EU Member State[4].

The need to comply with the EU framework has led to the introduction of an intricate legal framework under the Law Decree, with a complex allocation of responsibilities divided among EU and Italian institutions.

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State Guarantees of Bank Liabilities

Under the Law Decree the Italian Ministry of Economy and Finance ("**MEF**") is authorized to issue State guarantees (each a "**Guarantee**") of newly issued debt securities (including covered bonds[5]) of Italian banks (the "**Guaranteed Securities**") or as collateral provided in connection with Bank of Italy ELA facilities. The Guarantees may be granted until June 30, 2017, but this time limit may be extended by the MEF until December 30, 2017, subject to the prior approval of the EC.

A Guarantee may be issued only in compliance with the EU legal framework on State aid and following the approval of the EC of the guarantee scheme itself. While the approval of the general scheme has already been granted by the EC, a specific approval by the EC is required in certain cases, as detailed below.

Eligibility Requirements for the Issue of Guaranteed Securities

A Guarantee of newly issued debt securities may be granted in two scenarios:

- in cases where the bank applying for the issue of the Guarantee (i) fulfils its own fund requirements[6], and (ii) has not shown any regulatory capital deficiencies in the context of stress tests, asset quality reviews or similar exercises (the "**Eligibility Requirements**"); or
- in cases where the Eligibility Requirements are not met, if the applicant bank (i) demonstrates it has an urgent need for liquidity support (provided that its equity value is positive), or (ii) is subject to resolution or is a bridge institution under the BRRD framework.

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2 See, respectively, the Communication of the European Commission on the application, from August 1, 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis (the "**Banking Communication**") and Directive 2014/59/EU (the "**BRRD**").

3 See Article 32(4)(d) of the BRRD (implemented in Italy by Article 18 of the Italian Legislative Decree No. 180 of November 16, 2015 – the "**BRRD Decree**") as well as Article 18(4)(d) of the SRM Regulation (EU) No. 806/2014, according to which EPFS may take the form of (i) a State guarantee to back liquidity facilities provided by central banks, (ii) a State guarantee of newly issued liabilities, or (iii) an injection of own funds or purchase of capital instruments (subject to certain conditions, including that the bank is not failing or likely to fail). According to the BRRD, such measures shall be (i) confined to solvent banks, (ii) conditional on final approval under the EU State aid framework, (iii) of a precautionary and temporary nature. In addition, they must be proportionate to remedy the consequences of the serious disturbance and shall not be used to offset losses that the bank has incurred or is likely to incur in the near future.

4 According to the Banking Communication, State aid can only be granted on terms which involve adequate burden sharing by existing investors. Adequate burden sharing normally entails, after losses are first absorbed by equity, contributions by hybrid capital holders and subordinated debt holders. Hybrid capital and subordinated debt holders must contribute to reducing the capital shortfall to the maximum extent, in the form of either a conversion into Common Equity Tier 1 ("**CET1**") or write-down of the principal of the instruments. Contribution from senior debt holders (including deposits, bonds and all other senior debt) is not required as a mandatory component of burden sharing under State aid rules. An exception to the burden sharing requirement can be made where implementing such measures would endanger financial stability or lead to disproportionate results in accordance with para. 45 of the Banking Communication.

5 As defined and regulated under Article 7-bis of Law No. 130 of April 30, 1999.

6 See, in particular, Article 92 of the "CRR" Regulation (EU) No. 575/2013. The reference date for the purposes of this assessment is the date of the last supervisory reporting on own funds made by the applicant bank.

The satisfaction of the Eligibility Requirements shall be assessed by the Bank of Italy (or the ECB in case of significant institutions[7]) (the "**Competent Authority**").

EC Prior Approval and Restructuring Plan

Where the applicant bank does not satisfy the Eligibility Requirements, the issue of the Guarantee requires a specific prior approval by the EC in accordance with EU State aid rules.

In addition to such prior approval, within two months of the issue of a Guarantee any bank that did not meet the Eligibility Requirements must file a restructuring plan with the EC in order to confirm its profitability and ability to fund its business in the long term without public support[8]. The restructuring plan is required to be approved by the EC in compliance with EU State aid rules.

The obligation to file a restructuring plan within two months of the issue of the Guarantee also applies to a bank that satisfies the Eligibility Requirements, if the nominal amount of the Guaranteed Securities issued by such bank exceeds €500 million and 5% of its balance sheet liabilities.

EC Prior Approval and Restructuring Plan

	The bank fulfils the Eligibility Requirements	**The bank does not fulfil the Eligibility Requirements**
EC Prior Approval	No specific approval by the EC is required	The prior approval by the EC is required as a condition for the issue of the Guarantee
Restructuring Plan	A restructuring plan must be filed with the EC within two months of the issue of the Guarantee only if the nominal amount of the Guaranteed Securities issued by the bank exceeds €500 million and 5% of its balance sheet liabilities	A restructuring plan must always be filed with the EC within two months of the issue of the Guarantee

Application Process

The application to request the issuance of a Guarantee must be filed by the bank to the Bank of Italy and the MEF. The Bank of Italy shall then communicate to the MEF its assessment (or the assessment of the ECB, if the Bank of Italy is not the Competent Authority) as to the fulfillment of the Eligibility Requirements by the applicant bank.

If this assessment is positive[9], the Bank of Italy then communicates to the MEF the following:

- the adequacy of the conditions under which the liquidity support is granted and of the related volume;
- the amount of the bank's own funds;
- the amount of the Guarantee; and
- the fee due by the bank.

On the basis of such communication, the MEF notifies the applicant bank and the Bank of Italy of the issue of the Guarantee.

7 As identified in accordance with the Council Regulation (EU) No. 1024/2013 establishing the Single Supervisory Mechanism.

8 No restructuring plan needs to be submitted if the Guaranteed Securities are reimbursed within two months of their issue date.

9 The Law Decree does not specify the steps to be followed if the assessment is negative and it is accordingly unclear what is the procedure that applies in this scenario.

Features of the Guaranteed Securities

A Guarantee may only cover debt securities having all the features summarized in the following table.

Features of the Guaranteed Securities	
Issue date	After December 23, 2016 (whether or not the debt issuance programmes existed prior to such date)
Maturity	Between 3 months[10] and 5 years (or 7 years in the case of covered bonds)
Redemption	Bullet
Interest rate	Fixed
Denomination	Euro
Ranking	Senior
Structure	Structured securities, complex products or securities embedding a derivative component are not eligible
Classification	Instruments included in the own funds of the bank are not eligible

Limits to the Amount of Guaranteed Securities

The Law Decree also specifies that the nominal amount of securities issued by an applicant bank with a maturity exceeding 3 years that are eligible for a Guarantee in accordance with the above criteria shall not exceed 1/3 of the total amount of Guaranteed Securities issued by such bank. In addition, the total amount of Guaranteed Securities issued by an applicant bank shall normally not exceed its own funds.

Terms of the Guarantee

Each Guarantee is a first demand, unconditional and irrevocable guarantee, covering the payment of principal and interest under the Guaranteed Securities. The amount of a Guarantee is limited to that strictly necessary to restore the medium- and long-term financing capability of the applicant bank.

As consideration for the Guarantee, the bank must pay an annual fee to the MEF. The fee is determined on the basis of a risk assessment conducted in relation to each transaction and in accordance with the criteria specified in the Law Decree[11]. The fee must be paid quarterly in arrear and is calculated on the basis of the nominal amount of Guaranteed Securities issued by the bank.

Enforcement of the Guarantee

A bank that cannot make the payments due under the Guaranteed Securities must submit an application to the MEF and the Bank of Italy in order to request that such payments are made by the MEF under the Guarantee[12]. The funds that are necessary to make such payments are required to be made available by the MEF the day preceding the due date of payment. These funds are ring-fenced by operation of law in favor of the holders of the Guaranteed Securities and no other creditor of the bank may access to such funds[13].

The steps above do not limit the rights of noteholders of the Guaranteed Securities to take actions to directly enforce the Guarantee (the same applies to the holders of security interests in the Guaranteed Securities).

10 By way of derogation from the above limit, if the Eligibility Requirements are not met, the bank may issue Guaranteed Securities with a maturity of up to 2 months.

11 The fee structure comprises (i) a fixed amount of 0.40% or 0.50% (respectively if the maturity of the Guarantee Securities is at least equal to, or lower than, 12 months), and (ii) a variable amount calculated on the basis of the credit default swaps or rating of the bank. These criteria may be amended by the MEF. Any changes would not affect transactions already in place.

12 The application shall be submitted at least thirty days prior to the maturity date of any such obligation (except in cases of urgency).

13 The bank shall repay to the MEF the sums disbursed by the latter as a consequence of the enforcement of the Guarantee, plus interest accrued until the date of repayment. In addition, the bank shall present a restructuring plan to be submitted to the European Commission for the assessment of compliance with EU State aid rules.

Restrictions to Banks' Operations

Banks benefitting from the Guarantee must carry out their business in such a manner as not to abuse, or obtain undue benefits from, the Italian government financial support – such as through marketing communications addressed to the public.

If the Guarantee has been issued in favor of a bank which did not satisfy the Eligibility Requirements, for as long as the Guarantee is in force such bank is not allowed to:

- distribute dividends;
- make discretionary payments on Additional Tier 1 ("**AT1**") instruments;
- repurchase CET1 or AT1 instruments without the prior authorization of the EC; or
- purchase new shareholdings (save for certain exceptions[14]).

Guarantee on ELA Facilities

A Guarantee may also be issued to supplement the collateral used for the purposes of ELA facilities with the Bank of Italy, regardless of whether the applicant bank satisfies the Eligibility Requirements and provided that a restructuring plan is filed by such bank with the EC. The rules applying to the Guarantee on ELA facilities are mostly the same as those governing the Guarantee on debt securities.

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Precautionary Recapitalizations

Under the Law Decree the MEF is authorized until December 31, 2017 to underwrite or purchase ordinary shares issued by Italian banks (or related holding companies). Any bank which needs to strengthen its own funds given its stress test results in the adverse scenario may apply for Italian government support.

Application Process

As a pre-condition to the application for the capital injection, the bank must have previously submitted to the Competent Authority a plan to strengthen its capital (the "**Capital Plan**"). If the implementation of the Capital Plan is insufficient to achieve this goal, the bank may apply for a precautionary recapitalization by the State.

The application must be filed with the MEF and the Competent Authority (and in any event the Bank of Italy, if the Competent Authority is the ECB) and shall indicate:

- the amount of the requested capital injection;
- the net equity value and residual regulatory capital shortfall after the implementation of the Capital Plan; and
- the instruments and liabilities subject to burden sharing and related accounting value.

The bank must file a number of documents (including a restructuring plan for the purposes of EU State aid approval) together with the application[15] and shall expressly undertake to comply with the restrictions imposed under the Banking Communication[16].

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[14] These exceptions are those contemplated under EU State aid rules and include, in particular, any purchases of new shareholdings made for debt collection purposes or in order to provide temporary financial assistance to financially distressed companies.

[15] In particular, the bank must provide (i) an independent expert report attesting the economic value in a going concern scenario of the instruments and liabilities subject to burden sharing for the purposes of determining the related conversion ratio, (ii) an independent expert report on the value of the bank's assets and liabilities in a gone concern scenario, indicating the amount that would be attributed to the holders of the instruments and liabilities referred to under (i) in case of liquidation, (iii) the restructuring plan drafted in accordance with the Banking Communication, and (iv) if requested by the MEF, an indication of the current share value calculated by an independent expert on the basis of the criteria set out under the Law Decree.

The current share value shall serve as a basis to determine the value of the newly issued shares to be allocated to the MEF and the holders of instruments or liabilities subject to burden sharing, in accordance with the formula included in the Annex to the Law Decree. The values referred to under (i), (ii) and (iv) shall be further attested by an independent expert appointed by the Bank of Italy.

[16] See para. 47 of the Banking Communication, which provides for the application of mostly the same restrictions as those mentioned above in relation to Guaranteed Securities. Based on the decision taken by the European Commission under the Banking

The Competent Authority must communicate to the MEF the amount of own funds needed by the bank. Following such communication, a notification for State aid approval and the restructuring plan are filed with the EC. If the State aid approval is granted, the burden sharing and precautionary recapitalization measures would be adopted through MEF Decrees.

Burden Sharing

Burden sharing entails the total or partial conversion of AT1, Tier 2 and subordinated instruments or liabilities of the bank into newly issued ordinary shares, up to the amount necessary to cover the capital shortfall. Such measures shall be applied:

- in relation to all relevant instruments or liabilities, where possible on the basis of the laws applicable to the same, in accordance with the applicable insolvency ranking;
- *pari passu* and *pro rata* with respect to liabilities having the same ranking; and
- in compliance with the "no creditor worse off"[17] principle ("**NCWO**")[18].

The conversion ratio is determined on the basis of the criteria and formula specified in the Annex to the Law Decree[19].

As a consequence of the application of burden sharing measures, the bank's guarantees concerning the instruments or liabilities that are converted into shares are no longer effective. In addition, any agreements entered into by the bank in connection with its own shares or instruments and related to the economic rights attaching thereto are ineffective, where such agreements limit or prevent the full inclusion of these shares or instruments in the CET1 of the bank.

Recognition of Burden Sharing Measures and Judicial Redress

A key issue of burden sharing measures is connected with their potential recognition by competent courts. In this respect, according to the Law Decree the provisions on burden sharing are intended to qualify as (i) overriding mandatory provisions of Italian law for the purposes of the "Rome I" Regulation (EC) No. 593/2008 and Italian conflicts of law rules, and (ii) reorganization measures under the EU Directive No. 2001/24/EC on reorganization and winding-up of credit institutions.

Burden sharing measures may be challenged before Italian courts in accordance with the BRRD Decree. In case of misapplication or non-compliance with the NCWO principle, the compensation shall be equal to the difference between the liquidation value of the instruments or liabilities that have been converted into shares and the value received as a consequence of such conversion. Any compensation amount can only be paid through newly issued shares of the bank.

Preferred Treatment of Retail Investors through Equity/Debt Swap

Subject to the satisfaction of certain conditions (in particular, the execution of a settlement agreement with the bank) retail investors (as defined under the MiFID framework) affected by burden sharing measures are entitled to receive newly issued senior bonds[20] of the bank in exchange for the shares resulting from the

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Communication, the applicant bank may also be requested to limit the remuneration of directors and management and dismiss or replace its executive director(s) and general manager(s).

[17] In particular, pursuant to the Law Decree the holders of the converted instruments are required to be treated no worse than in the case of liquidation of the bank (assuming that no financial support is given by the State in a liquidation scenario).

[18] The bank shall also ensure that all convertible instruments are converted into shares or other CET1 instruments in accordance with their terms and conditions.

[19] The values to be applied for the purposes of the conversion in the case of a precautionary recapitalization of MPS are directly specified in the Law Decree – as follows: (i) MPS Capital Trust II Preferred Securities will be converted at 18% of their face value; (ii) outstanding AT1 securities (other than those mentioned under (i) above) will be converted at 75% of their face value; (iii) outstanding Tier 2 securities will be converted at 100% of their face value. The 2008 "FRESH" instruments are not expressly mentioned in the Law Decree.

[20] The bonds shall have a maturity comparable to the residual maturity of the instruments that have been subject to burden sharing and their yield must be aligned to the market yield of similar senior bonds issued by the bank. The nominal amount of the bonds corresponds to the price to be paid by the MEF in connection with the purchase of the shares, which is equal to the lower of (i) the value attributed to the newly issued shares for the purposes of the conversion / burden sharing measures, and (ii) the price that was originally paid by the investor to subscribe or purchase the converted instruments.

conversion of the instruments previously held by them (provided that such instruments were purchased before January 1, 2016).

The equity/debt swap mechanism is structured so that the shares are purchased by the bank in the name and on behalf of the MEF. The shares are transferred to the MEF and the related price is paid by the MEF to the bank in connection with the issue of the senior bonds.

Step 1 – Precautionary Recapitalization and Burden Sharing

Step 2 – Equity/Debt Swap with Retail Investors

Next Steps

Some Italian banks (MPS, Banca Popolare di Vicenza and Veneto Banca) have already issued Guaranteed Securities, while precautionary recapitalizations by the government and burden sharing measures are expected to occur in the forthcoming months.

The Law Decree lays down a comprehensive framework on how such measures should be adopted. However, some aspects of the new regime are unclear, which may lead to uncertainties concerning its application. For instance, it is currently being debated whether the Guarantee may be enforced if Guaranteed Securities are subject to bail-in. In addition, the application of burden sharing measures to certain capital instruments issued by Italian banks may give rise to legal issues and possible disputes, also considering that some of these instruments are not governed by Italian law and are subject to the jurisdiction of foreign courts.

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