How state aid survived the Italian banking crisis

There is much to admire in the EU's handling of the Italian banking crisis, but in allowing two lenders to escape BRRD rules, it has raised questions on the consistency of the EU state aid and resolution framework.

June 2017, the European Central Bank (ECB) declared that two Italian banks, Veneto Banca (VB) and Banca Popolare di Vicenza (BPVI) were "failing or likely to fail." But rather than the two lenders being subject to the EU's bank resolution and recovery directive (BRRD), the Single Resolution Board (SRB) allowed them to be liquidated under Italian insolvency law.

It was seen as a controversial step in some quarters and raised the question of why the Italian banks were spared the bail-in legislation and the BRRD rules designed specifically to resolve failing financial institutions.

What went wrong in Veneto

Italy has the largest number of non-performing loans (NPL) in the entire European banking sector following a prolonged recession. But the downfall of the Veneto banks is only partially attributable to the stagnation of the Italian economy in the last decade, and was rather caused by weak management practices deriving from their nature of cooperative "popular" banks (banche popolari)—namely, the modalities used to determine their share price and the loans disbursed to their clients to finance the subscription of their shares.

As the banks' shares were not listed, their value was determined each year by the boards of directors of the two banks and approved by their shareholders, in accordance with the Italian rules for non-listed cooperative companies. This mechanism progressively inflated the share value of the two Veneto banks, which continued to grow while the share price of listed popular banks was sensibly shrinking, and reached a peak of €62.5 (BPVI) and €39.5 (VB) per share in 2014. A large number of the banks' clients (including retail investors) invested their savings in the banks' shares, being also attracted by the exponential growth of the share value. Clients of both Veneto banks were able to trade their shares with the banks themselves or other shareholders, and the existence of this "internal market" for the shares was ensuring a minimum degree of liquidity to their investments.

> **Downfall of the Veneto banks is only partially attributable to the stagnation of the Italian economy**

The banks' shares subsequently became illiquid due to both a steady decrease in clients' demand and the restrictions on the purchase by banks of their own shares introduced under the CRR (Regulation (EU) No. 575/2013), which limited the ability of the two banks to support the liquidity of the shares starting from 2014. This gave rise to disputes with clients, who were no longer able to monetize their investments by selling their shares. Clients' discontent was further exacerbated when the price per share was reduced to €48 (BPVI) and €30.50 (VB) in 2015, mainly as a consequence of the €758.5 million (BPVI) and €968.4 million (VB) losses suffered by the banks in 2014.

The banks accumulated additional losses of €1.4 billion (BPVI) and €881.9 million (VB) in 2015, following on-site inspections conducted by the ECB in that year. The ECB requested that they deduct the value of the loans and other forms of financings that they had granted to their clients to fund the purchase of their own shares from their CET1, as imposed by the CRR rules. Capital ratios deteriorated also as a consequence of impairments and losses on the loans' portfolio.

In 2016, the Renzi government introduced new rules requiring popular banks with assets exceeding €8 billion to convert to joint stock companies. The two Veneto banks resolved to change their legal form, raise new capital and list their shares via an initial public offering (IPO) on the Italian Stock Exchange. However, the IPOs of both banks failed and they were finally rescued by the Atlante fund—an alternative investment fund made up of Italian private and public investors (such as banking foundations and major financial institutions)—which subscribed to the entire capital increase of the banks at a price of €0.10 per share and became (almost) their sole shareholder with 99.33 percent of the share capital of BPVI and 97.64 percent of VB.

€8 billion

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Notwithstanding the struggle of the new management to restore clients' confidence, on June 23, 2017, VB and BPVI were declared "failing or likely to fail" by the ECB due to repeated breaches of capital requirements. On the same date, the SRB decided that resolution action in accordance with the BRRD and the rules governing the Single Resolution Mechanism (SRM) was not in the public interest and that, accordingly, the banks had to be liquidated under normal Italian insolvency proceedings. Then, on June 25, 2017, the Italian government put both banks into compulsory liquidation proceedings (liquidazione coatta amministrativa) in accordance with the special rules specifically introduced under the Law Decree No. 99/2017.

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A resolution outside the BRRD framework

In essence, under Law Decree No. 99/2017, the two Veneto banks have been liquidated through a BRRD-like resolution diverging from the BRRD principles on burden sharing and state aid.

The “good” assets of the two banks (including performing loans and tax assets) were transferred to Intesa Sanpaolo, along with senior liabilities (including deposits, state-guaranteed and other senior bonds) and other relationships (employees, shareholdings in other banks, branches, etc.). All other assets and liabilities (including, in particular, the claims of shareholders and subordinated bondholders) remained with the banks under liquidation proceedings, except for non-performing loans, which shall be transferred to Società per la Gestione delle Attività (SGA) —the Italian “bad bank” established in 1997 in connection with the restructuring of Banco di Napoli.

State aid was granted mainly in the form of cash injections to cover the capital absorption deriving from the acquisition of the “good banks” and public guarantees on certain obligations and undertakings of the banks. Retail and certain other investors that purchased subordinated bonds issued by the banks shall be compensated through the special fund created by the government to indemnify the subordinated bondholders of the four lenders (Banca delle Marche, Banca Etruria, CariFerrara and CariChieti) that were resolved in November 2015.

Although they were presented under a different label, the measures adopted by the Italian government are equivalent to the combined application of the sale of business, asset separation and bail-in tools in the context of a BRRD resolution, except for two major differences. Firstly, senior liabilities of the Veneto banks were not subject to burden sharing, which could have been the case if resolution authorities had exercised their bail-in powers under the BRRD/ SRM rules. Secondly, the resolution of the two banks was financed through public funds, rather than through a full bail-in of senior liabilities or the use of resolution funds or deposit guarantee schemes in accordance with the BRRD/ SRM framework.

The EC decision under the Banking Communication

Under EU law, if a bank is failing or likely to fail and the conditions for a resolution under the BRRD are not satisfied, the bank must be liquidated in accordance with the liquidation proceedings applicable under national law. The BRRD is however silent on whether and to what extent state aid can be granted in a normal insolvency scenario.

On June 25, 2017, the European Commission (EC) approved the state aid measures provided under the Law Decree No. 99/2017 and confirmed that outside the EU banking resolution framework, there is room for national governments to seek state aid approval under Article 107 of the Treaty on the Functioning of the European Union (TFEU) and the EC Communication on state aid in the banking sector of 2013 (so-called “Banking Communication”).

Article 107(3)(b) of the TFEU allows national governments to adopt state aid measures in order to “remedy a serious disturbance in the economy of a Member State”. Under the Banking Communication, in such circumstances, state aid is permitted only on terms resulting in an adequate burden sharing among those who invested in the bank—particularly shareholders and subordinated creditors (but excluding senior creditors).

Against this background, the EC acknowledged that the liquidation of VB and BPVI under the ordinary Italian liquidation proceedings would have determined a serious economic disturbance in the Veneto region, and agreed that existing shareholders and subordinated creditors of the banks fully contributed to the costs of the intervention as required by the Banking Communication.

The “too-small-to-fail” paradox

Veneto is one of the richest regions of the Eurozone. It accounts for a non-negligible portion of the Italian GDP and has a solid industrial sector that is traditionally based on the efforts and work of a multitude of SMEs and individual entrepreneurs. The Bank of Italy said in a report to the Italian parliament that in the absence of state intervention, the liquidation of the Veneto banks could have forced approximately 100,000 SMEs and 200,000 households into the early repayment of the loans due to the banks under liquidation proceedings (worth around €26 billion), which could have led to widespread insolvencies and additional losses for the banks’ creditors. The Italian deposit guarantee scheme would not have been able to reimburse the banks’ insured depositors—unless through extraordinary contributions of Italian banks—and the government would have become liable to pay €8.6 billion as a consequence of the enforcement of the state guarantees covering senior bonds recently issued by BPVI and VB.

Against this background, the EC decision was welcomed in Italy as the lesser evil (if not a blessing) from a political standpoint. Yet this decision came as a surprise to several commentators, as it somehow appears to be at odds with the goals and spirit of the EU banking resolution framework. While the philosophy behind the BRRD is that public money should be used as a measure of last resort to rescue “too-big-to-fail” institutions, the case of the Veneto banks seems to show that public financial support can be granted under more permissive conditions for “smaller” banks—assuming that BPVI and VB could be considered as such.

Taking the EC decision to its extreme consequences, the corollary of this approach is that the risk of a serious economic disturbance in a region of an EU Member State may allow national governments to use public funds in a way that would otherwise be forbidden under the BRRD/ SRM rules to address a risk of significant adverse effects on and contagion to the stability of the financial system as a whole. Intuitively, one could argue that the system should work the other way round.

There are of course several arguments that justify this paradox—including that the state aid and BRRD/ SRM rules pursue different goals, that the "public interest" principle must accordingly be interpreted in different ways and that the use of public funds outside the BRRD rules may actually contribute to preventing financial disruption and restoring confidence in the banking system. However, the acceptance of the above corollary could ultimately undermine the consistency of the EU banking resolution framework.

EU authorities should avoid applying a "two-tier" resolution regime for "systemic" and "non-systemic" banks, which could lead to unfair treatment of investors in different resolution or insolvency scenarios. In addition, the application of such a "two-tier" regime may be seen as a form of state aid per se, as "non-systemic" banks could potentially benefit from an implicit state guarantee on—and, consequently, reduced funding costs for—their senior liabilities (which could be subject to burden sharing under the BRRD/SRM framework, but not necessarily under the Banking Communication).

Finally, the adoption of different resolution approaches may give rise to possible issues for senior debt holders when the bank is approaching a point of non-viability, and to possible legal challenges to resolution actions taken by competent authorities.

The political angle of the EU approach

Looking at the negotiations that occurred at the EU level before the two Veneto banks were liquidated and in the broader context of the Italian banking crisis, the decisions taken by the EU authorities are likely to be read as the outcome of a political compromise allowing the Italian government to rescue its banking system.

A notable element of the SRB decision is that the simultaneous insolvency of two significant institutions subject to the direct supervision of the ECB and operating in the most productive region of the third national economy of the Eurozone, which were widely considered to be among the largest and most important lenders in Italy, was not considered to be "sufficiently serious" to trigger the application of the BRRD and SRM rules. It remains to be seen whether the SRB will take the same approach in similar cases rather than diverge from this precedent.

> **A two-tier resolution regime for "systemic" and "non-systemic" banks could lead to unfair treatment of investors**

Italy claims that limited public support was given to its banks at the time when several EU banks were being bailed out. The problems emerged at a later stage, after stricter rules under the Banking Communication and BRRD came into force. In the last few years, Italian authorities have endeavored to restructure the Italian banking system without infringing EU rules, and have somehow managed to do so in an innovative way with a package of measures. These include introducing a state-guaranteed scheme to facilitate the securitization of NPLs (so-called GACS), sponsoring the creation of the Atlante fund, and promoting the use of "voluntary support" measures to distressed banks using the Italian depositary guarantee scheme. The Italian government has also granted extraordinary public financial support to some Italian lenders in the form of state-guaranteed bonds, state guarantees on emergency liquidity assistance or precautionary recapitalization. At the same time, it has introduced significant and long-awaited changes to the rules applying to popular and other cooperative banks, notwithstanding the opposition encountered from several stakeholders.

Meanwhile the Italian banking market went through a huge restructuring process, which is ongoing. Big popular banks have been transformed into joint stock companies; some of them have merged already and others are expected to consolidate their businesses. UniCredit successfully completed a €13 billion capital increase (the largest in Italian history), the "good banks" resulting from the resolution actions taken by the Bank of Italy in 2015 have been sold to UBI, and Banca Monte dei Paschi has been recapitalized through a capital injection by the state and the application of burden sharing measures to its shareholders and subordinated bondholders.

Within this context, the prospects for Italian banks after the rescue of BPVI and VB appear to be brighter and safer, if seen from the offices of EU institutions in Brussels and Frankfurt, and this has likely been the ultimate rationale underpinning the decisions taken with respect to the Veneto banks.

The way forward for Italian banks

Stronger initiatives need to be taken by Italian competent authorities to prevent mis-selling of financial products as well as to enhance the awareness of retail investors. MiFID2 will offer new tools to this end—including rules on product governance and intervention, independent advice, bundling of products, etc.—and should generally strengthen the supervision on product engineering and distribution to retail clients. These new requirements, coupled with a stricter approach by supervisors, could help channel an increased portion of retail investments towards financial products with no (or reduced) bail-in risks, at the same time inducing Italian banks to diversify their funding sources by issuing an increased portion of bail-in-able debt to institutional investors.

The new rules on the minimum requirement for own funds and eligible liabilities (MREL) that are currently being discussed at the EU

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EU authorities should clarify the interplay between state aid rules and the BRRD/SRM framework

level could facilitate this trend, by providing for more transparency on the composition of MREL-eligible capital and the possibility to split the senior debt class into "preferred" and "non-preferred" liabilities. This latter measure could allow Italian banks to offer instruments carrying a lower bail-in risk (such as "senior preferred" notes) to retail investors, while shifting a significant portion of the bail-in risk onto institutional holders of "senior non-preferred" notes and subordinated debt.

Further clarifications needed on EU state aid and resolution rules

EU authorities have unexpectedly proven to be flexible and open to different solutions when addressing the Italian banking crisis. This may be good news considering the magnitude of NPLs that must be disposed of by the European banking system as a whole and the additional restructurings that could affect EU banks. To a certain extent, Italy has been a forerunner in tackling the NPL problem through a mix of private and public instruments—including the use of national asset management companies—which are now also sponsored by the Council, and it is possible that some of the solutions tested in Italy will be used to facilitate the disposal of NPLs or restructure other distressed institutions in the EU.

However, such flexibility comes with legal uncertainties and potential risks for the Banking Union. EU authorities should clarify the interplay between state aid rules and the BRRD/ SRM framework in order to ensure that the EU banking resolution rules remain credible. Although protecting retail bondholders and non-insured depositors from burden sharing could be seen as a praiseworthy objective, doing so at the expense of legal certainty may not be desirable, as it could create competitive distortions in the internal market.

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