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Hearing on Decree Law 237/2016 Urgent measures for the protection of savings in the banking sector

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Introduction

Decree Law 237/2016 must be seen in the context of an economy, like Italy's, affected by structural weaknesses and still recovering from the effects of the international financial crisis nearly ten years after its onset. It must be noted that, since then, GDP fell by about 9 percentage points and the industrial production index by nearly one fourth.

The contraction in economic activity caused a significant increase in non-performing loans, whose stock has, however, recently started to decrease with the moderate economic recovery. The worsening in credit quality during this time has affected the profitability of banks, who on several occasions closed their balance sheets with losses. In some cases, management errors and irregularities also weighed on credit quality.

Adding to the difficulties stemming from the economic climate were delays in the restructuring of the banking sector and an insufficient capacity to adapt to technological innovations. Greater responsiveness on both fronts would have laid the foundation for more resilient and enduring profitability.

Regulatory changes pose new and difficult challenges to the entire banking sector on several fronts; those made in relation to crises will call upon banks to compete in the market to set up the buffer of minimum resources that is required by the legal framework (TLAC and MREL).

In this context I would like to underline two points.

In recent years, the Italian reforms aimed at resolving certain structural problems in the banking sector have been significant, but their effects have not been fully felt or, in some cases, they have not been fully implemented.

Some Italian banks, of which not only small-sized banks, experienced particularly significant problems. The decree law provides an important contribution to resolving these problems, in full compliance with international regulations on liquidity and capital.

I will focus on these measures and will describe the characteristics of the Monte dei Paschi di Siena intervention. I will analyse the other provisions of the decree law and will conclude with an overall assessment of the provisions issued.

1. The decree law's public support measures

The decree law contains measures for the public support of banks in need of liquidity and capital. These measures, for which up to €20 billion has been allocated, comply with the European framework on State aid and on the management of banking crises.

2.1 Liquidity

The liquidity support measures, provided for under Title 1 of the decree law, consist of guarantees granted by the State on liabilities issued after the decree law's entry into force and on emergency liquidity assistance (ELA) provided by the Bank of Italy. The guarantee is intended to support the bank's ability to collect funds, facilitating the issuance of new securities and increasing the availability of instruments accepted by the market or the Bank of Italy as collateral for financing transactions.

The conditions to access the guarantee scheme, its fees, the characteristics of the liabilities guaranteed and the obligations that the beneficiary banks must assume comply with the European Commission's guidelines on State aid. Guarantees may be issued until 30 June 2017, with an option to extend for a further six-month period subject to the European Commission's approval.

The banks that request it can access the guarantee scheme through different procedures according to their situation:

i) direct access for banks that meet the minimum (Pillar 1) capital requirements and do not have a capital shortfall according to stress tests conducted at national or European level;

ii) access requiring prior approval, on a case by case basis, from the European Commission for banks that do not meet the minimum requirements or those with a capital shortfall (provided that they have a positive net worth), banks under resolution or bridge institutions.

In the first scenario the procedure for accessing the guarantee scheme is governed by Article 7 of the decree law. It provides for a tight timeframe and a clear division of responsibilities among the various institutions involved in the procedure, in order for the guarantee to be granted usually within 8 days of the bank's request. The competent authority, either the ECB for significant banks or the Bank of Italy for the other banks, assesses whether the conditions to access the guarantee scheme are met. If they are met, the Bank of Italy will:

assess the adequacy of the conditions and the size of the intervention requested in light of the bank's size and capitalization; calculate the fee owed by the bank to the Ministry of Economy and Finance (MEF), according to a formula set by the decree law which takes into account, among other things, the bank's risk level and the State's creditworthiness; communicate to the MEF, usually within 3 days of the bank's request, its assessment and, for significant banks, the ECB's assessment. The MEF will usually issue the guarantee within 5 days of the Bank of Italy's communication. The MEF and the Bank of Italy have already published on their respective websites the necessary forms and instructions for requesting a guarantee.

In the second scenario the issuance of the guarantee follows a similar procedure, but is subject to the European Commission's prior approval.

The guarantee on newly issued liabilities may only be granted on non-subordinated financial instruments with specific duration and financial characteristics.

The instruments must have a residual maturity ranging from three months to five years (except for covered bonds, which may have a residual maturity of up to seven years); those with a residual maturity of more than three years must not exceed one third of the bank's total guaranteed liabilities; the redemption must come in the form of a bullet payment at maturity; the yield must be at a fixed rate; structured instruments, complex products, and instruments with derivative components are ineligible.

For banks that access the guarantee without the European Commission's prior approval, the guarantee is limited to instruments maturing within two months.

The Bank of Italy provides ELA on a discretionary basis, but the conditions under which it may be provided are set by the ECB. Specifically, the banks that request it must have adequate collateral, to which is applied a valuation haircut based on the quality of the collateral itself. The state guarantee provided for by the decree law makes it possible for the amount of eligible collateral to grow, increasing the possibility for banks to access this form of financing.

In general, the amount of the guarantee is limited to what is strictly necessary to restore the bank's medium- and long-term financing capacity.[1] To protect competition and to limit the risks for public finances, the decree law contains constraints for banks which receive a guarantee; additional obligations are triggered when, to access the guarantee scheme, an individual request is required or a particularly large amount is requested.

For as long as they benefit from the state guarantee, banks must avoid abusing the support received in advertising and commercial practices, by means of example. Banks that access the guarantee scheme without having made an individual request may not distribute

[1] Usually, it must not exceed the amount of own funds for supervisory purposes. In derogation of the rule, the Bank of Italy may, on a case by case basis, find requests exceeding own funds appropriate, so long as they are justified.

dividends, make redemption payments or other payments on capital instruments (except when contractually obligated), or acquire new shares, except for shares acquired for purposes of debt recovery or those acquired to provide temporary financial assistance to firms in distress. Restructuring plans which confirm the bank's profitability and long-term ability to collect funds without recourse to public assistance must be submitted, within two months of the granting of the guarantee, when the nominal value of the guaranteed financial instrument is higher than €500 million and more than 5% of the requesting bank's total debt and when the requesting bank does not meet the minimum capital requirements or has a capital shortfall (except, in the latter case, when the guarantee is limited to liabilities maturing within two months).

2.2 Precautionary recapitalization

Title II of the decree law focuses on public recapitalization measures, or the possibility of the State to underwrite increases in bank capital.

To understand the mechanism under the decree law, it is important to clarify two essential elements of the current regulatory framework, present in the Bank Recovery and Resolution Directive (BRRD) and the European Commission's guidelines on State aid.

In general, the BRRD assumes that, in the presence of a public support measure, a bank is in crisis and must therefore be placed under resolution or, if the conditions for resolution are not met, be liquidated.[2] A 'precautionary' public intervention aimed at strengthening capital (without triggering the crisis procedures) is however permitted when a shortfall is identified under the adverse scenario of a stress test conducted at national or European level or by the Single Supervisory Mechanism,[3] to remedy a serious disturbance in the economy and to preserve financial stability. The rationale behind this mechanism is that a bank, even if solvent, may be perceived by the market as being excessively risky under adverse stress conditions, circumstances which could themselves cause a deterioration of the bank's situation and its insolvency. Precautionary recapitalization may therefore resolve cases in which information asymmetries create obstacles to the proper functioning of market mechanisms, generating risks for the individual banks and for financial stability.

[2] Article 32(4)(d).

[3] Stress tests are simulations which assess the future stability of banks. In Europe, the test typically examines the three-year period following a recent reference date, set according to the availability of data. It includes a baseline macroeconomic scenario and an adverse scenario, which hypothesizes the impact of one or more particularly severe shocks. The European stress tests, like the one whose results were published last July, are coordinated by the European Banking Authority (EBA) and conducted by the ECB for euro-area banks under its direct supervision. In the last stress test, to the sample of large European banks subject to the stress test coordinated by the EBA (about fifty), the ECB added the other minor significant institutions not included in the EBA's sample.

Precautionary recapitalization may be provided if certain additional conditions are met:

i) it may only be directed to banks that are not to be placed under resolution or liquidated;

ii) it must be temporary in nature;

iii) it may not be used to cover losses, existing or expected;

iv) before requesting public assistance the bank must have tried, without success, to raise the necessary funds in the market;

v) the intervention must be approved by the European Commission, which – in addition to what I will discuss shortly – will ask the bank to provide a detailed and credible restructuring plan aimed at fully restoring the bank's stability and profitability.

In addition to complying with the BRRD, the precautionary recapitalization must be deemed compatible with the State aid framework by the European Commission.[4] The Commission requires, among other things, that burden sharing measures be applied: a sacrifice on the part of the bank's shareholders (which in this case consists of the dilution of their holdings following the State's intervention and the conversion into equity of the subordinated bonds) and holders of hybrid and subordinated instruments (who will have to accept the conversion into equity of these instruments, in whole or in part, as necessary).[5] Instead, the bail-in tool is excluded, that is, the involvement of the bank's non-subordinated creditors.

This premise allows us to understand two of the decree law's key characteristics. First, access to public support is limited to banks that are not failing or likely to fail, but which need to strengthen capital as identified under the adverse scenario of a stress test. Second, the burden sharing measures only involve shareholders and holders of hybrid and subordinated bank bonds, excluding other creditors.

[4] The Commission has developed a set of criteria to assess the legitimacy of State aid in the credit sector through a series of acts. The most recent and relevant is the 2013 Banking Communication.

[5] In any case, the sacrifice made by shareholders and creditors must respect the no creditor worse off principle: the shareholders and bondholders subject to a conversion should not receive a treatment worse than they would have received under normal insolvency proceedings.

These characteristics clearly distinguish the measures that the State may offer under the decree law from those extended to the four banks placed under resolution in November 2015. At the time, those banks were already failing or likely to fail and had to undergo the procedure provided for by the BRRD. The sacrifice imposed on the shareholders and subordinated creditors was inevitably greater. However, it was possible to avoid the involvement of other creditors because the resolution procedure was activated immediately after the entry into force of the Italian law transposing the directive, but before the start of 2016, when the bail-in tool entered into effect.

Burden sharing on the part of private investors is a requirement for public intervention; it aims at, among other things, lessening the burden on the State. The first and most important form of protection for society nevertheless consists of, with regard to precautionary recapitalization, the fact that the beneficiary bank is not failing or likely to fail. Once the bank has overcome its temporary moment of difficulty, it may then see its value grow, to the benefit of its creditors and shareholders, public and private. Drawing on the experience of other countries, in the majority of cases the State has profited from its interventions.

A third distinguishing feature of the decree law is the compensation mechanism for retail investors who will receive new shares as a result of burden sharing. The MEF may purchase these shares; in exchange, investors will receive ordinary bonds from the bank (issued at par by the bank or a company that is part of the same group) for a value equal to the amount paid by the MEF for the purchase of the shares. This mechanism may be accessed under limited circumstances: compensation may only be provided to retail investors, not qualified or professional investors; the MEF may intervene in support of a settlement agreement between a bank and these investors to avoid or resolve a dispute concerning the selling of converted instruments.

The procedure applies to financial instruments which legally require a prospectus in order to be tendered and which were initially subscribed by retail investors or were purchased by retail investors in the secondary market; in the latter case, the financial instrument must have been purchased from another retail investor or within the context of investment services offered by the issuing bank or a company that is part of the same group.

The decision to provide protection to small investors meets the criteria of fairness and aims at preserving financial stability. In fact, it prevents the risk of the bank finding itself facing legal action on the part of small investors, which could compromise the bank's recovery; more generally, it contributes to preserving the public's trust and the orderly functioning of the financial system. A protection mechanism seems appropriate especially during this transition phase between the old and new crisis management regime in which the new instruments are still imperfect and the old ones can no longer be used. Once fully operational, the presence of a minimum requirement for eligible liabilities (MREL), subscribed by informed creditors, may render the relationship between banks and investors less in need of extraordinary remedies.

2. Monte dei Paschi di Siena

Following the failure of the capital raising plan aimed at private investors, a precondition to accessing public support measures, on 30 December 2016 Monte dei Paschi di Siena (MPS) requested the Italian state to effect a precautionary recapitalization. On that occasion, an initial outline for a restructuring plan was submitted, based on the business plan prepared for the purposes of the unsuccessful capital raising plan. The plan is expected to go forward and strengthen the recovery actions taken by MPS in recent years, further reducing costs and streamlining its operational structure.

MPS expects to complete a new restructuring plan shortly. State intervention may be finalized only after the European Commission approves this plan, following a procedure that involves the ECB, the European Commission and the Bank of Italy, called upon to offer technical support to the MEF.

As the competent authority responsible for supervising MPS, the ECB has already established the amount of the bank's precautionary recapitalization at €8.8 billion. This amount is higher than the amount the bank aimed to collect on the market (€5 billion) because of the precautionary recapitalization mechanism provided for by the BRRD and transposed into the decree law. Details on the two different quantifications of MPS's capital shortfall were published on the Bank of Italy's website.[6]

The plan must be approved by the European Commission. The Bank of Italy is responsible for a series of tasks necessary to ensure the equal treatment of creditors with the same characteristics and that the no creditor worse off principle is respected. In this capacity, the Bank of Italy has received the certification from the independent experts it appointed, which includes (see below): the economic value attributable to the instruments to be converted, needed to establish the number of new shares to be assigned to the holders of these

[6] See *The 'precautionary recapitalization' of Banca Monte dei Paschi di Siena*, published on 29 December 2016 (*https://www.bancaditalia.it/media/approfondimenti/2016/ricapitalizzazione-mps/index.html*).

instruments; the actual value of MPS's assets and liabilities without any form of public support and assuming that MPS was subject to liquidation on the date of the request; and, in such case, how much would be paid pro rata to each holder of instruments potentially convertible into shares. In their report, the independent experts found that the no creditor worse off principle was respected.

All subordinated securities outstanding when the request for precautionary recapitalization was made will be converted into equity; their total nominal value amounts to €4.3 billion. They consist of four issues of additional Tier 1 instruments (totaling €431 million) and seven issues of Tier 2 instruments (totaling €3.9 billion). The issues were made between 2000 and 2010.

The decree law requires that the economic value of the liabilities subject to conversion be determined, which serves as a basis for calculation. The value is provided by the bank when it requests public intervention and must be certified by the independent experts.[7] In the case of MPS the additional Tier 1 instruments will be converted at 75 per cent of their face value (excluding the FRESH 2003 issue, which will be converted at 18 per cent of face value); the Tier 2 instruments will be converted at their par value. These values were set directly in the decree law.

Given these values, the formulas provided in the annex to the decree law allows for the calculation of the unit price and the number of shares to offer in exchange. The unit price is also the same for shares purchased by the MEF.

3. Other measures

Title IV of the decree law contains additional urgent measures for the banking sector.

A) Contributions to the National Resolution Fund

The National Resolution Fund, established by the Bank of Italy and financed by contributions from the entire Italian banking system, holds all the shares of the four banks under resolution: Nuova Banca delle Marche, Nuova Cassa di Risparmio di Ferrara, Nuova Cassa di Risparmio di Chieti and Nuova Banca Popolare dell'Etruria e del Lazio, in addition to those of the REV, the company created to acquire the impaired assets transferred from the banks in question.

[7] The costs of the experts appointed by the Bank of Italy are borne by the requesting bank.

The completion of the sale of the four banks makes it necessary for the Fund to incur additional expenses in the amount of €1.5 billion. Utilizing the provisions of the 2016 Stability Law and the Regulations of the Single Resolution Mechanism, at end of 2016 the Bank of Italy called up two contributions for an amount totaling 1.5 billion.

With regard to the resources available for the Resolution Fund, the 2016 Stability Law (L. 208/2015, Article 1(848)) established that whenever the resources of the Fund were insufficient to cover the costs of the four banks' resolution measures, the banking system could be called upon to make an additional contribution in an amount to be determined by the Bank of Italy, within the maximum limit allowed for contributions in accordance with Regulations of the Single Resolution Mechanism.

Article 25 of the decree law states that the Bank of Italy may establish that contributions to the National Resolution Fund be called in the two years following the reference year and that actual payment by the banks take place within a five-year timeframe.

This provision allows the banking system's contributions to be allocated over time in a manner that is more flexible, efficient and consistent with the actual financial needs of the National Resolution Fund, allowing for the costs borne by the banks to be spread out over several years.

B) Other measures to support bank liquidity

Article 26 of the decree law contains additional measures to support bank liquidity, encouraging the use of loans to customers as collateral in refinancing operations that the Bank of Italy carries out on behalf of the Eurosystem, thereby incentivizing the extension of credit to households and firms.

It pertains to measures which in part are not new: they incorporate temporary regulations introduced with the 2011 'Salva Italia' Decree and extended numerous times up to 2016.

It includes three measures: 1) in order to make the security interest legally enforceable, the Bank of Italy no longer has to notify the customers of their banking counterparts that the credit extended to them has been pledged as collateral in favour of the central bank; 2) the debtor of the pledged credit may not impair the security interest, in whole or in part, by setting off any claims owed by him to the counterpart pledger, irrespective of when these counter-claims arose, were acquired or became payable; 3) when the pledge used to secure these transactions relates to a mortgage loan, the Bank of Italy is exempt from the obligation to note the existence of the pledge in the real estate registers.

Similar regulations are already present in other euro-area jurisdictions (including France, Spain, Slovenia and Belgium); their adoption in the Italian legal system would place its banking system on equal footing with that of those countries.

In the absence of these regulations, the acceptance of bank loans as collateral for monetary policy operations could have encountered significant operational difficulties, almost insurmountable for mortgage loans to households; furthermore, additional haircuts would have had to be applied in the near future, so as to reduce the liquidity obtainable in connection with a given portfolio of eligible loans.

4. Conclusion

The measures adopted by the Government in the decree law follow on from measures that in recent years were directed at strengthening a banking system hard hit by the crisis, so that it may return to fully support Italian firms and households, especially during this phase of moderate recovery.

The State measures to strengthen bank capital under the decree law aim at avoiding that a bank's hypothetical difficulties (those that emerge during a stress test) translate into actual difficulties, with consequences for the bank and the overall stability of the financial system. It operates within the confines of the applicable European legal framework and may be activated upon the occurrence of certain conditions. It reduces, at least in part, our banking system's competitive disadvantage, which by European comparison has not yet benefitted from State aid except to a very limited extent.

Burden sharing is required under the European legal framework; it involves investors of subordinated instruments, correspondingly reducing the burden on the State. The compensation mechanism for retail investors of these instruments is motivated by the need to avoid denting the confidence that investors place in banks and the need to protect, in a phase of transition to the new regulations, individuals who may not have understood the nature of the subordinated instruments they had subscribed.

The application of the decree law to MPS represents a turning point for the bank and removes, even in the perception of the market, a high risk for the entire Italian banking system. The recent developments on the sale of the four banks placed under resolution in November 2015 appear to demonstrate that even this second important source of uncertainty is about to be eliminated. Resolving these problems entails high costs, but these costs must be properly compared with those that would have been incurred with inaction. Finally, signs of improvement continue with regard to non-performing loans. The economic recovery, however modest, is also a contributing factor, as are the legislative measures launched in the past two years to accelerate recovery procedures and improve their efficiency.

However, the underlying challenges that banks are today called upon to face must be kept in mind: the recovery of adequate profitability, the modernization of their business model and the streamlining of their organizational structures and geographical presence, also by means of mergers that may reduce costs and increase efficiency. The decree law does not aim to resolve these challenges, nor could it do so. However, it represents a key step forward in Italy’s gradual exit from the crisis.